Can the Global Economy Be a Mixed Economy?[1]

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A great achievement of this century was the domesticating of the brute power of laissez-faire capitalism. The nation-state accomplished this task in multiple ways. It pursued economic stabilization and steady growth through an active macro-economic policy. It regulated the more self-destructive tendencies of markets, especially banks and financial markets. It empowered trade unions and put a floor under labor, and later environmental, standards. It provided social income in various forms of social insurance. And it made direct public investments.

All of this made for a more socially bearable, as well as a more economically efficient, brand of capitalism. It tempered capitalism's extremes, both the volatility and the inequality. Increased stability also enhanced the political and economic bargaining power of ordinary people, which rooted the mixed economy in a majority politics.

In principle, the shift to global laissez faire is an unmitigated good because of the efficiency of the price system. From this perspective, the regulations and stabilizing policies are mere "distortions," whose elimination will only produce better allocation of economic resources. But this view ignores that the domestic policy interventions were necessitated in the first place by irremediable market failures, in sectors of the economy where market forces cannot by themselves optimize outcomes.

When critics point to the destabilizing tendencies of global capital flows, they are often disparaged as simple protectionists or allies of special interest groups. But there is something more fundamental at stake. The fact is that the mixed economy of the postwar era was a magnificent achievement, and global free markets undermine the project of maintaining a mixed, managed, and regulated economy at home, in several reinforcing ways. And it is an entire economic system—its institutions, its politics, as well as its economics, that is undermined by the resurrection

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of laissez faire, with great costs to stability, security, opportunity, growth, and democratic citizenship.

Capital is mobile and labor is not. There is, of course, no global sovereign to regulate and manage. Global laissez faire tends to price out of world markets nations that elect to have policies of high wages and generous social benefits. It pulls capital into corners of the globe where there is less regulation, which in turn makes it harder for the advanced nations to police their banks, stock exchanges, capital markets, and social standards.

Globalism also influences the domestic political balance—in favor of the forces that want more globalism. Labor and social democratic parties seem unable to deliver the benefits they once did of secure jobs, high and rising earnings, good social benefits. Working people either stop voting, as they do in the U.S., or they internalize the values of the new economy and conclude that the lower economic horizons are their own problem. The slogan of the new economy might as well be, Anyone can be Bill Gates, and if you're not Bill Gates, it's your own fault.

Investors, who are free to move money to locations of cheap wages and scant regulation, gain power at the expense of citizens whose incomes are mainly based on wages and salaries. That tilt, in turn, engenders more deregulation and more globalism. The global money market, not the democratic electorate, becomes the arbiter of what policies are "sound." In this climate, a Democratic president, a Labour prime minister, a Social-Democratic chancellor can snub the unions, but he'd better not offend Wall Street, or the City of London, or Frankfurt. So even the nominally left party begins behaving like the right party—which then alienates the natural base of the party that is supposed champion of the mixed economy.

There is an emergent set of global regulatory authorities, but they are stunningly undemocratic. Domestically, central bankers operate at one remove from political accountability. Globally, the IMF and the World Bank operate at two removes. The World Trade Organization addresses issues of fair play that concern investors, but not workers or citizens. Even worse, the WTO lacks evolved rules of evidence, due process, public hearings, and the strictures against conflict of interest that characterize courts in mature democracies.

Increasingly, global quasi-official standard-setting authorities, dominated by private business, are laying down the rules of global commerce. So the century-old project of making raw capitalism socially bearable is undermined in countless ways by globalism. Domestically, there are regulatory mechanisms, and political constituencies. These are neatly swept away by leaving everything to markets in the name of free trade. The global market trumps the domestic mixed economy.

At the Bretton Woods conference in 1944, the architects of the postwar financial and payments system had a profound understanding of the deflationary bias of private financial speculation. Countries subject to the pressure of private money markets were under pressure to maintain sound currencies; they would respond with slower domestic growth, and try to export their unemployment through protection or competitive deflation, or both. At best, this would lead to global slow growth. At worst, as in the interwar period, it would lead to depression and a backlash of desperation and dictatorship.

The IMF was intended to remove the business of exchange rates from these private speculative pressures, and to create a bias toward expansion. It is ironic in the extreme that an institution, the IMF, that was created precisely as a bolster against the irrationality of speculative private capital flows, has turned into both a battering ram to make these countries havens for speculators, and an agent of gratuitous austerity.

Historically, center-left parties have been in favor of a managed economy at home and mostly free trade internationally. While some on the left believe that it is free commerce in goods and services that undermines high-paid jobs at home, free commerce is on the whole beneficial, though all commerce rests on a prior legal structure of rules. The more serious problem is the laissez-faire regime in capital and currencies, for it creates both speculative instability and a systemic bias toward slow growth.

During the Bretton Woods era, in fact, there was not free trade in currencies, there was the legacy of capital controls, there were all kinds of non-tariff barriers, and there was emergent freer trade within the Europe of the six, but far less pressure to admit low-wage imports. It was easier to profess support for free trade in that era, because we did not have free trade. And somehow, we had high growth and full employment. Was that a coincidence?

We need, in short, a kind of global economic regime that allows the mixed economy to flourish at home. Does this mean adding labor rights to the WTO? Does it mean regional free trade within a North Atlantic area that has roughly the same regulatory and social standards, but a retention of some barriers between this free trade area and areas that do not respect basic social standards—a shift from the principle of unconditional Most Favored Nation treatment (MFN) to a new form of conditional MFN intended to prevent a "race-to-the-bottom"? Do we need the re-regulation of global financial markets, to slow down their speculative aspect? What might we do to reclaim the IMF as an agent of expansion rather than austerity?

The neo-liberal story would have us believe that the current, moderately benign, economy is the only possible one. In the U.S., deregulation of labor and product markets, freer trade, and freer global capital movements are given credit for the improving trade-off between inflation and unemployment. If that is true, and we follow the neo-liberal recipe, the income gaps will only widen, and we will continue to lose the levers of management of a mixed market economy. But the dirty little secret of the new economy is that economic performance, even on average, is far below its potential, even leaving aside the economic extremes of wealth and poverty in the U.S. and the high unemployment in Europe.

In the mixed economy of the postwar era, for the first time in the history of capitalism ordinary working people had rising living standards coupled with social supports and economic security. Our task is to reinvent a mixed economy for a new era, and to figure out what kind of global economic context is compatible with a managed market economy at home, and what kind of politics is necessary to support that project.

Center-left governments now simultaneously govern in every major European nation for the first time in history—London, Paris, Rome, and Berlin. Of the fifteen nations of the European Union, no fewer than thirteen are governed by democratic-left parties. Liberal democrats also occupy the executive branch in Washington and Ottawa.

This stunning convergence entails a double irony. Supposedly, this is the supreme capitalist moment. Yet in nation after nation, voters evidently don't like the effects of capitalism in the raw. At the same time, however, it is not at all clear that these very de-radicalized leftists can do much to temper the market. For the most part, their policies are slightly more benign versions of the same neo-liberal policies put forth by their center-right predecessors. Indeed, many on the left have moved to the center not so much out of choice or even political tactic, but because globalized capitalism seems to leave them little alternative. Left programs can no longer deliver, absent a radical change in the rules of the global market economy.

The question, then, is whether they will muster the will and the strategy to change those ground rules, to reclaim space for national policy. Europe offers an alternative social model, but unless Europeans act in concert to challenge constraints of the global market, they do not have a viable economic model.

Intuitively, the recipe commended by neo-liberals seems attractive: let markets set prices; let free trade and free movements of global capital work their efficient magic. If voters don't like the social consequences, use the state to temper the extremes and give the displaced new opportunities and skills. But this view is naive. Tempering the excesses of the market requires public outlays and regulations. Yet if the world is one big free market, capital tends to avoid nations that impose burdens on it. Moreover, as the founders of the postwar financial system at Bretton Woods grasped, leaving currency values and capital movements to financial speculators leads to competitive devaluations and deflation.

The collapse of the Bretton Woods system of managed exchange rates, in 1971-73, ushered in a period of slow growth. François Mitterrand learned painfully, as the first Socialist president of France during the early 1980s, that a nation that tries to grow faster than its neighbors is rewarded with a run on its currency. Since then, the market has only grown more powerful and the policy levers of nation-states more stunted. Even in a nation with fiscal discipline, tough regulatory strictures, or generous social benefits and the taxes required to pay for them, will frighten away investors.

As a result, most center-left governments are mainly reduced to accepting the discipline of the global market, and tinkering around the edges. Their first priority is to reassure capital markets. In the U.S., the Clinton administration is enjoying the effects of a modest and uneven boom based on very orthodox fiscal policy aimed at winning the confidence of the Federal Reserve and Wall Street. Expensive new social programs are off the table. Existing social programs such as Medicare and Social Security are in retrenchment.

In Britain, the highly popular Tony Blair is consciously emulating Clinton. Most of Blair's energy has gone toward modernizing Britain's institutions of government. Fiscal and monetary policy are entirely orthodox; indeed, Blair went the Tories one better by privatizing the Bank of England. Privatization is accelerating, including even plans to privatize partially the London Underground. While Blair is modestly increasing social spending, he is selling off public assets in order to find money to spend on public investments that he can't finance via taxation or public borrowing.

On the continent, where unemployment remains stuck around 12 percent, most left-of-center governments are placing their bets on conservative fiscal policies combined with heroic measures to improve education and training. They hope to partially deregulate labor markets and reform taxes that discourage job creation so that industry will take on more workers. They are, however, somewhat more venturesome in their willingness to revise the rules of global capital flows.

Everywhere, deficit reduction and relatively slow growth are the order of the day. In the U.S., the slow growth takes the form of wage stagnation for the bottom half of the workforce. In Europe, where a variety of regulatory and redistributive policies still militate against U.S.-style inequality, the slow growth takes the form of high unemployment. The prevailing, feeble form of social democracy is not likely to change this economic trajectory very much. And if tinkering is their only contribution, the current spate of moderately left governments will likely be repudiated by the voters.

Is there no alternative? Is policy essentially dead?

There is certainly nothing wrong with "supply-side" policies aimed at improving the quality and productivity of the workforce. All Western nations can benefit from better educated workers, lifetime learning policies, and other measures to make the labor market work better. It would also be smart to reduce payroll charges, which are now more than 20 percent in the U.S. and more than 60 percent in some of Europe. But these policies have their limits.

For example, the French Socialists under Lionel Jospin and the German SPD are promoting measures such as a shorter work week. Yet as European employers emulate their American counterparts and turn to temporary workers and outsourcing, the assumption that the state can legislate a "normal" workweek is unrealistic. With slow overall growth, mandating a thirty-five-hour week with forty hours of pay will produce inflation. But a mandatory cut in both hours and pay, while non-inflationary, will produce moonlighting, and defeat the whole purpose. Shorter working time is the fruit of higher growth, not the engine.

Labor market policies, by themselves, do not add up to higher growth rates. They can work as complements to a more expansionary macroeconomic policy, not as substitutes. The Swedish Keynesians figured this out more than four decades ago. The recipe is to run as hot a macroeconomic policy as you dare without triggering inflation, and then complement it with active labor market policies to match well-trained workers with employers. When unemployment gets down to a level that runs the risk of wage inflation, you enlist the unions in voluntary wage restraint, and soak up the remaining joblessness with retraining sabbaticals and public employment.

But Swedish Keynesianism doesn't work very well anymore. The culprit is the global economy. Global growth is held hostage to creditors and financial speculators. And countries with good wages and expensive social outlays find themselves priced out of the market.

There is, I think, an alternative to simply accepting a downward convergence of wages and benefits as an inevitable price to be paid for the "efficiency" of the global market. But this alternative will require a fundamental shift in how center-left governments view global capital. For the most part, American liberals and European social democrats have not challenged the neo-liberal view that all prices are efficiently set by markets. Yet there is a surprisingly strong dissent being heard from mainstream economists who hold that there is one major exception to this rule—the price of currencies and the flow of global capital.

In the past two years, such mainstream economists as Jeffrey Sachs of Harvard, Paul Krugman of MIT, Barry Eichengreen of the University of California at Berkeley, Joseph Stiglitz, formerly of Stanford and now chief economist of the World Bank, and Jagdish Bhagwati of Columbia, formerly economic advisor to the director-general of the GATT, have all challenged whether free flows of capital and laissez-faire setting of currency parities actually optimize outcomes.

In the May-June 1997 issue of *Foreign Affairs*, Bhagwati, one of the most eminent and passionate of free trade economists, wrote a startling article contrasting trade in goods with trade in capital and currencies. "Only an untutored economist will argue," Bhagwati wrote, "that free trade in widgets and life insurance policies is the same as free capital mobility." The reason is simple. Trade in ordinary goods and services tends to reach equilibrium. But global capital markets often tend to overshoot, pricing currencies wrong, pouring capital in and yanking it out, doing serious damage to the real economy.

A good case in point is the Asia crisis. Foreign capital seeking super-normal returns abruptly swamped these newly liberalized capital markets. When overbuilding ensued and returns began sagging, the capital rushed out, devastating the currencies and economies. Bhagwati wrote, "When a crisis hits, the downside of free capital mobility arises. To ensure that capital returns, the country must do everything it can to restore the confidence of those who have taken the money out. This typically means raising interest rates. . . ." But higher interest rates only deepen local recession. Investors are "reassured" at a devastating cost to the real economy.

The International Monetary Fund, which comes in to "restore confidence" (and supervise a fire sale) often serves as a handy scapegoat. But the deeper problem is the neo-liberal regime and its encouragement of short-term speculative capital flows to fragile economies in the first place. And those same speculative capital movements constrain the policy options of advanced economies.

Systemically, the effect of free capital mobility is not just periodic crises but a deflationary bias for the system as a whole, as nations competitively manipulate interest rates and exchange rates to reassure investors. In a downturn, this can take the form of competitive devaluations, as in Europe in the 1930s and Asia in the late 1990s. In an inflationary period, it can take the form of high real interest rates, as in Europe and America in the 1980s. The common effect is needless instability, creditor hegemony, slow growth, and pressure on nations to jettison high wages and decent social benefits.

In a limited sense the critique is also tacitly shared by Robert Rubin and Alan Greenspan. For although global capital flows are more or less free and currency values are more or less set by market forces, governments and central bankers do recognize, if only through periodic ad hoc interventions, that the stakes are simply too high to let speculative capital and currency swings determine the fate of the real economy.

Five times in the past two decades, the U.S. and the other great powers have intervened in very significant ways to counteract the impulses—and the damage—of speculative forces in capital markets. These included the concerted intervention in late June 1998 to prevent the yen from crashing and taking the Asian economy with it; the Mexican rescues of 1983 and 1995; the Louvre Accord of 1988 to stabilize the dollar against the yen; and the Plaza Accord of 1985, which produced a period of coordinated reductions in interest rates.

Note that three of these occurred under the Reagan administration, which elsewhere was fiercely committed to free markets. Note also that the recent coordinated moves to shore up the yen were undertaken out of fear that a weakening yen would trigger a chain of devaluation throughout Asia and very serious recession—more market irrationality. The Western powers have pressed the Chinese to continue pegging the Hong Kong dollar to the U.S. dollar and to continue defending the Chinese yuan—two more violations of the idea that currency values should be set by market forces.

But while Western governments are willing to engage in ad hoc interventions to contain crises, they are uneasy about returning to a more regulated regime for private capital flows and exchange rates. However, re-regulation of capital flows is precisely what is needed if left-of-center governments are to reclaim the capacity to pursue policies of high growth and social justice.

Casual students of U.S. history read of the centrality of the "money issue" in nineteenth-century American politics—the fringe parties, the battles over gold, silver, and greenbacks—and wonder whether our great-grandparents were afflicted by some kind of collective financial hysteria. In reality, the underlying issue was whether credit would be cheap or dear, whether capital markets would be run for the advantage of creditors or ordinary people, and whether periodic financial panics and depressions would be contained or seen as the inevitable side effects of progress and efficient markets. Precisely the same issues arise today globally.

By the same token, casual observers of the mid-century economy fail to appreciate the importance of the Bretton Woods system. Bretton Woods fixed exchange rates. But by committing central banks to support the fixed rates collectively, it also precluded speculative currency trades or capital movements. The latter was its more important achievement. Regulation of global capital thus created shelter in which it was possible for national governments to build high-employment, high-growth welfare states, free from the downward competitive pressure of global money markets.

Happily, the advent of the euro will make it easier to begin restoring something like Bretton Woods. It is very likely that the relative values of the three major currencies—the dollar, yen, and euro—will be tightly managed by their respective governments. The run-up to the euro has already resulted in lower interest rates, and an associated economic boost, for many of the European nations with historically weak currencies, such as Italy.

The question is whether the concert of center-left governments will take the next step and also pursue strategies to limit speculative global capital flows. For example, Professor James Tobin's proposed tax on financial transactions, long scorned by free-market economists, is getting a respectful second hearing, as analysts look for ways to rein in private global money markets. Another good idea was devised by Chile, certainly no enemy of free markets. The Chileans required any foreign investor to place 30 percent of the amount of the investment on deposit with the Chilean central bank for a year, as insurance against capital flight. They suspended this requirement in 1998, because their more laissez-faire neighbors were successfully competing for capital. But a global regime that rewarded longer-term cross-border investments and punished purely speculative ones would be salutary. Such measures move the world back toward regulated capital markets. Removing currency values and capital movements from purely speculative swings and resulting recessions such as the current Asia panic would allow both higher growth and more managed national economies.

The world's governments need to take these questions seriously—both to create more domestic room for policy and to allow the world a higher rate of growth. The ancient question of how market forces need to be tempered for the greater good of the economy and the society is now a global one. Either the irrationality of global capital flows will be tempered once again by democratically elected governments, or those governments and their democratic electorates will continue to be enfeebled by the world's money markets.