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Lecture Five

The Way Ahead

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In these lectures, I have offered a conceptual framework for a better understanding of human events. These events are not determined by timelessly valid scientific laws. Such laws exist, of course, but they are not sufficient to determine the course of events. The complexity of the situations is one reason, and the role of the participants' thinking is another.

I have focused on the reflexive, two-way connection between the participants' thinking and reality, and I emphasized the causal role that misunderstandings and misconceptions play in shaping reality. Both these influences have been strangely ignored. They introduce an element of uncertainty into the subject matter which, except in the simplest situations, make it impossible to predict the future.

One can still sketch out various plausible scenarios and evaluate their likelihood. One can also prescribe desirable outcomes. I have done both, many times. Indeed, I can claim to have specialized in it, focusing on *predictions* as an investor and *prescriptions* as a philanthropist. I have been successful enough in the former to be able to afford the latter. I should like to devote today's discussion to this dual task.

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We are at a moment in which the range of uncertainties is unusually wide. We have just passed through the worst financial crisis since World War Two. It is quantitatively much larger and qualitatively different from other financial crises. The only relevant comparisons are with the Japanese real estate bubble which burst in 1991 and from which Japan has *still* not recovered, and with the Great Depression of the 1930s. What differentiates this crisis from the Japanese experience is that the latter was confined to a single country, while this crisis has involved the entire world. What differentiates it from the Great Depression is that this time the financial system was not allowed to collapse but was put on artificial life support.

In fact, the magnitude of the credit and leverage problem we face today is even greater than in the 1930s. In 1929, total credit outstanding in the United States was 160% of GDP and it rose to 250% by 1932; in 2008 we started at 365%—and this calculation does not take into account the pervasive use of derivatives which was absent in the 1930s. And yet, in spite of that, the artificial life support has been successful. Barely a year after the bankruptcy of Lehman Brothers, financial markets have stabilized, stock markets have rebounded, and the economy is showing signs of recovery. People want to return to business as usual and think of the Crash of 2008 as a bad dream.

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I regret to tell you that the recovery is liable to run out of steam and may even be followed by a “double dip” although I am not sure whether it will occur in 2010 or 2011.

My views are far from unique but they are at variance with the prevailing mood. The longer the turnaround lasts the more people will come to believe in it but in my judgment, the prevailing mood is far removed from reality. This is characteristic of far-from-equilibrium situations when perceptions tend to lag behind reality. To complicate matters, the lag works in both directions. Most people have not yet realized that this crisis is different from previous ones—that we are at the end of an era. Others—including me—failed to anticipate the extent of the rebound.

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The confusion is not confined to the financial sphere; it extends to the entire international arena.

After the collapse of the Soviet empire the United States emerged as the sole superpower. No other power, or combination of powers, could challenge its supremacy. But the uni-polar world order did not take root. When President Bush sought to assert America’s supremacy by invading Iraq on false pretences he achieved the exact opposite of what he intended. The United States suffered a precipitous decline in its power and influence. So the disarray in the international financial system is matched by instability in international relations. The new world

order that will eventually emerge will *not* be dominated by the United States to the same extent as the old one.

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To understand what is happening we need a different conceptual framework from the one to which we have been accustomed. The efficient market hypothesis looks at financial markets in isolation and totally disregards politics. But that gives a distorted picture. As I have pointed out several times, behind the invisible hand of markets there is the *visible* hand of politics which establishes the rules and conditions in which the market mechanism operates. My conceptual framework relates to the *political* economy, not the market economy as an abstract construct that is governed by timelessly valid laws. I look at financial markets as a branch of history.

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The international financial system, as it was reconstructed after the Second World War, did not create a level playing field; it was lopsided by design. The international financial institutions—the International Monetary Fund and the World Bank—were organized as shareholding companies in which rich countries held a disproportionate share of the votes and also controlled the boards. This put the countries at the periphery at a disadvantage vis-à-vis those at the center.

Ever since, the system has been dominated by the United States. At the Bretton Woods conference, Lord Keynes proposed but it was the head of the American delegation, Harry White, who disposed. Since then, we have gone from an almost completely regulated system to an almost completely deregulated one but the changes were led by the United States and the system has continued to be guided by what has become known as the Washington Consensus.

Although the rules laid down by the Washington Consensus are supposed to apply to all countries equally, the United States—as the issuer of the main international currency—is more equal than the others. Effectively the international financial system has a two-tier structure: Countries that can borrow in their own currency constitute the center, and those, whose borrowings are denominated in one of the hard currencies, constitute the periphery. If individual countries get into difficulties they receive assistance but only on strict conditions. That holds true whether they are from the center or from the periphery. But if the center *itself* becomes endangered, then, preserving the system take precedence over all other considerations.

That happened for the first time in the international banking crisis of 1982. If the debtor countries had been allowed to default, the banking system would have collapsed. Therefore the international financial authorities banded together and introduced what I called at the time “the collective system of lending.” The lenders were induced to roll over their loans and the debtor countries were lent enough additional money to service their debts. The net effect was that debtor countries fell into severe recession—Latin America lost a decade of growth—but the

banking system was allowed to earn its way out of a hole. When the banks built up sufficient reserves the loans were restructured into so-called Brady bonds and the banks were wrote of their remaining losses.

Something similar happened again in 1997 but by then the banks had learned to securitize their loans so they could not be forced into a collective system of lending and most of the losses had to be taken by the debtor countries. This set the pattern: the debtor countries were subjected to harsh market discipline but when the system was in danger, the normal rules were suspended. Banks, whose collective failure would have endangered the system, were bailed out.

The financial crisis of 2007/2008 was different because it originated at the center and the periphery countries were drawn into it only after the bankruptcy of Lehman Brothers. The IMF was faced with a novel task: to protect the periphery from a storm that originated at the center. It did not have enough capital but, member countries banded together and raised a trillion dollars. Even so, the IMF has had some difficulties in coping with the situation because it was designed to deal with problems in the public sector and the shortage of credit was impacting mainly the private sector. But, on the whole, the IMF adapted itself to its novel task remarkably well.

Overall, the international financial authorities have handled this crisis the same way as previous ones: They bailed out the failing institutions and applied monetary and fiscal stimulus. But this crisis was much bigger and, at first, the same techniques did not work. The rescue of Lehman Brothers failed. That was a

game-changing event: financial markets actually ceased to function and had to be put on artificial life support. This meant that governments had to effectively guarantee that no other institution whose failure could endanger the system would be allowed to fail. That is when the crisis spread to the periphery because periphery countries could not provide equally credible guarantees. This time it was Eastern Europe that was the worst hit. The countries at the center used the balance sheets of their central banks to pump money into the system and to guarantee the liabilities of commercial banks, and governments engaged in deficit financing to stimulate the economy on an unprecedented scale.

These measures have been successful and the global economy appears to be stabilizing. There is a growing belief that the global financial system has once again escaped collapse and we are slowly returning to business as usual. This is a grave misinterpretation of the current situation. Humpty Dumpty cannot be put together again. Let me explain why.

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The globalization of financial markets that took place since the 1980s was a market fundamentalist project spearheaded by the United States and the United Kingdom. Allowing financial capital to move around freely in the world made it difficult to tax it or to regulate it. This put financial capital into a privileged position. Governments had to pay more attention to the requirements of international capital than to the aspirations of their own people because financial capital could move around more freely. So as a market fundamentalist project,

globalization was highly successful; individual countries found it difficult to resist it. But the global financial system that emerged was fundamentally unstable because it was built on the false premise that financial markets can be safely left to their own devices. That is why it broke down and that is why it cannot be put together again.

Global markets need global regulations, but the regulations that are currently in force are rooted in the principle of national sovereignty. There are some international agreements, most notably the Basel Accords on minimum capital requirements, and there is also good cooperation among market regulators. But the source of the authority is always the sovereign state. This means that it is not enough to restart a mechanism that has stalled; we need to create a regulatory mechanism that has never existed. As things stand now, the financial system of each country is being sustained and supported by its own government. The governments are primarily concerned with their own economies. This tends to give rise to financial protectionism, which threatens to disrupt and perhaps destroy global financial markets. British regulators will never again rely on the Icelandic authorities and countries at the periphery will be reluctant to be entirely dependent on foreign-owned banks.

The point I am trying to make is that regulations must be international in scope. Without it, financial markets cannot remain global; they would be destroyed by regulatory arbitrage. Businesses would move to the countries where the regulatory climate is the most benign and this would expose other countries to risks they cannot afford to run. Globalization was so successful because it forced

all countries to remove regulations but, the process does not work in reverse. It will be difficult to get countries to agree on uniform regulations. Different countries have different interests which drive them towards different solutions.

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This can be seen in Europe. And if European countries cannot agree among themselves, how can the rest of the world? During the crisis, Europe could not reach a Europe-wide agreement on guaranteeing its financial system; each country had to guarantee its own. As things stand now, the Euro is an incomplete currency. It has a common central bank but it does not have a common treasury—and guaranteeing or injecting equity into banks is a treasury function. The crisis offered an opportunity to remedy this shortfall but Germany stood in the way.

Germany used to be the driving force behind European integration but that was at a time when Germany was willing to pay practically any price for reunification. Today's Germany is very different. It is at odds with the rest of the world in fearing inflation rather than recession and, above all, it does not want to serve as the deep pocket for the rest of Europe. Without a driving force, European integration has ground to a halt.

Fortunately, Europe had the benefit of the social safety net. It held down European growth rates in good times, but it served its purpose in the downturn and the recession in Euroland turned out to be less severe than expected. Now that the fears of an economic collapse have subsided, the European Union is showing some

signs of political revival. The European Central Bank has effectively bailed out the Irish banking system and Ireland has resoundingly endorsed the Lisbon Treaty. So one should not be too pessimistic about Europe.

The fact that the financial crisis is having different long-term impacts on different countries may turn out to be more of a problem. In the short term, all countries were negatively affected, but in the long term there will be winners and losers. Although the range of uncertainties for the actual course of events is very wide, shifts in relative positions can be predicted with greater certainty. To put it bluntly, the United States stands to lose the most and China is poised to emerge as the greatest winner. The extent of the shift is already exceeding most expectations. There will be significant changes in the relative positions of other countries as well but from a global perspective the one between the United States and China is the most significant.

The United States has been at the center of the international financial system ever since the Second World War. The dollar has served as the main international currency and the United States has derived immense benefits from it but lately it has abused its privilege. Starting in the 1980s it has built up an ever increasing current account deficit. This could have continued indefinitely because the Asian tigers, first under the leadership of Japan and then of China, were willing to finance that deficit by building up their dollar holdings, but the excessive indebtedness of United States households brought the process to an end. When the housing bubble burst, households found themselves overextended. The banking system has suffered tremendous losses and has to earn its way out of a hole. In

commercial real estate and leveraged buyouts, the bloodletting is yet to come. These factors will continue to weigh on the American economy and the American consumer will no longer be able to serve as the motor for the world economy.

To some extent, China may be able to take its place. China has been the primary beneficiary of globalization and it has been largely insulated from the financial crisis.

For the West in general, and the United States in particular, the crisis was an internally generated event, which led to the collapse of the financial system. For China, it was an external shock which hurt exports but left the financial, political and economic system unscathed.

China has discovered a remarkably efficient method of unleashing the creative, acquisitive, and entrepreneurial energies of the people who are allowed to pursue their self-interest while the State can cream off a significant portion of the surplus value of their labor by maintaining an undervalued currency and accumulating a trade surplus. So China is likely to emerge as the big winner.

China is not a democracy and the rulers know that they must avoid social unrest if they want to remain the rulers. Therefore they will do anything in their power to maintain economic growth at 8 percent and create new jobs for a growing workforce. And they have plenty of power because of the trade surplus. China can stimulate its domestic economy through infrastructure investments and it can foster its exports by investing in and extending credits to their trading partners. After all,

that is what China was doing when it was financing its exports to America by buying US government bonds. Now that the American consumers have to cut back, they can develop relations with other countries. So China will be a positive force in the world economy while the United States will be limping along.

The Chinese economy is of course much smaller than the United States; with a smaller motor, the world economy is likely to move forward at a slower pace. But within these limits a tectonic shift is taking place between the United States and China with third parties reorienting themselves toward the source of positive impulses. The shift may not be permanent or irreversible—just think of the rise and fall of Japan Inc.—but at the present moment, it constitutes the most predictable and significant trend in the global political economy and China is pulling along its trading partners like Brazil and some African and Asian countries. India is doing well based on domestic growth.

The success of Chinese economic policy cannot be taken for granted. The infrastructure investment in the Chinese hinterland may not generate self-sustaining economic growth. Under the Chinese system, the return on new investments is generally very low because investment decisions are dictated by political rather than commercial considerations. On the previous two occasions, the relaxation of bank credit has produced a spate of bad loans. This time it may be different, because there has been a shift in power from the regional to the central authorities, and the local officials of the banks are no longer under the control of the provincial authorities—but success cannot be taken for granted. Moreover, China may be dragged down by a global slowdown. But if China flounders, the

global economy loses its motor. Therefore the relative success of China is more assured than its absolute success.

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We are at a moment in history which, in some ways, is comparable to the end of the Second World War. Then the prevailing system had actually collapsed and a new one had to be built from scratch. At Bretton Woods, the victorious powers proved equal to the task. Inspired mainly by Lord Keynes, they built a system that could accommodate the entire world even if the United States was more equal than others. Now, the prevailing multilateral system—call it international capitalism—did not fully collapse but it has been greatly weakened, its inherent flaws have been revealed, and it is challenged by a viable alternative. The rise of China offers a fundamentally different form of economic organization than the current international financial system. It may be given the label of “state capitalism” as distinct from the international capitalism championed by the Washington Consensus. We are at the end of an era, but we are not fully aware of it.

The two forms of economic organization—State Capitalism and International Capitalism are in competition with each other. Neither of them is attractive. The Washington Consensus has failed. International capitalism in its present form has proven itself inherently unstable because it lacks adequate regulation. It is also highly unjust. It favors the haves over the have nots.

At the same time, an international system based on state capitalism would inevitably lead to conflicts between states. The first signs of conflict are already beginning to surface because, ironically, China is repeating the mistakes of the colonial powers in dealing with the countries that are rich in natural resources just at a time when the colonial powers have learned from their past mistakes and are trying to rectify them. In order to gain access to natural resources, China is dealing with the rulers and neglecting the people. This helps oppressive and corrupt regimes to stay in power. This is an undesirable outcome but China is not the only one to be blamed for it. When a Chinese company tried to buy Unocal, it was rebuffed. And more recently, Rio Tinto reneged on a deal to sell an interest to a Chinese company. This has pushed China into dealing with those countries that the international financial institutions have shunned—Burma, Sudan, Zimbabwe, the Congo and Angola stand out. Guinea is the latest example. This is becoming a source of considerable friction which is not in the best interests of China, let alone the rest of the world. But China considers itself the aggrieved party and remains reluctant to join the Extractive Industries Transparency Initiative. This has become the biggest obstacle to the continued success of that initiative.

While the prevailing multilateral system will try to reconstitute itself, China will expand on a bilateral basis. China is, of course, part of the multilateral system but it does not occupy within that system a position that is commensurate with its current strength; therefore its participation in the international financial institutions is rather passive and its active expansion is likely to go through bilateral channels. For instance, China will complain about the role of the dollar and will promote the role of Special Drawing Rights but it is unlikely to allow the renminbi to become

freely convertible because that would destroy the mechanism that has allowed the state to harvest the fruits of cheap Chinese labor through an undervalued currency. China will continue to maintain capital controls but will establish bilateral clearing accounts denominated in renminbi with countries like Brazil. This will diminish the status of the dollar as the international currency without replacing it.

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To sum up: the world is facing a choice between two fundamentally different forms of organization. We may label them international capitalism and state capitalism. The former, represented by the United States, has broken down and the latter, represented by China, is in the ascendant. The path of least resistance leads to the gradual disintegration of the international financial system as we know it. Yet a system of bilateral relations is liable to generate conflicts between states. A new multilateral system based on sounder principles needs to be invented. That would serve the best interests of both the United States and China and of course the rest of the world.

While international cooperation is almost impossible to achieve on a piecemeal basis, it may be attainable in a grand bargain where the entire financial order is rearranged. The emergence of the G20 as the primary forum of international cooperation and the peer review process adopted at the Pittsburgh meeting are steps in the right direction. But the G20 has to operate within the confines of the Articles of Association of the IMF because changing the Articles is a long drawn-out process.

That is what a new Bretton Woods conference could accomplish in one fell swoop. It would reconstitute the IMF to better reflect the prevailing pecking order among states and revise its methods of operation. It would decide how to treat financial institutions that are too big to fail and it would consider new rules to control capital movements. The total freedom of financial capital to move around internationally has proved to be a source of instability and needs to be curbed.

The use of the dollar as the main international currency has produced dangerous imbalances. The dollar no longer enjoys the trust and confidence it once did, yet no other currency is in a position to take its place. There is a general flight from currencies into gold and other commodities and tangible assets. That is harmful because it keeps those assets out of productive use and stokes the fear of inflation.

The United States ought not to shy away from the wider use of Special Drawing Rights (SDRs). That should induce China to abandon its peg to the dollar and that would be the best way to reduce international imbalances. Since SDRs are denominated in several national currencies, no single currency would enjoy an unfair advantage.

The range of currencies included in the SDRs would have to be widened and some of the newly added currencies, which would include the renminbi, may not be fully convertible. Therefore the dollar could still reestablish itself as the preferred reserve currency, provided it is prudently managed.

One of the great advantages of SDRs is that they allow the international creation of money. That would be particularly useful at times like the present. The money could be directed to where it is most needed. That would be a great improvement over what is happening currently. A mechanism which allows rich countries that don't need additional reserves to transfer their allocations to those who need them is readily available, and has already been used on a small scale.

The reorganization of the prevailing world order may have to extend beyond the financial system if we are to make progress in resolving issues like global warming and nuclear proliferation. It may have to involve the United Nations, especially membership of the Security Council.

The process needs to be initiated by the United States, but China and other developing countries ought to participate in it as equals. They are reluctant members of the Bretton Woods institutions which are dominated by countries that are no longer dominant. The rising powers need to be present at the creation of the new order to ensure that they will be active supporters of it.

Why should the United States initiate changes in a system of which it had been the main beneficiary? Because the system cannot survive in its present form and the United States has more to lose if it is not in the forefront of reforming it. America lost a lot of power and influence during the Bush presidency. Without far-sighted leadership, the relative position of the United States is likely to continue eroding. The United States is still in a position to lead the world. It can no longer

impose its will on others, as the Bush administration sought to do, but it could lead a cooperative effort which would involve not only the developed but also the developing world. This would reestablish American leadership in an acceptable form.

Why should China submit to a new multilateral system in view of the fact that it is set to emerge as the winner from the current turmoil? The answer is equally simple. In order to continue rising it must make itself acceptable to the rest of the world. That means that it must move towards a more open society, combining an increased measure of individual freedom with the rule of law. Given the current military power relations, China can continue rising only in a peaceful environment where the rest of the world willingly accepts the rise of China.

It is even more important for the sake of a peaceful world that the United States should find its proper place in a new world order. A declining superpower losing both political and economic dominance but still preserving military supremacy is a dangerous mix.

And, as I have tried to show, democracy is in deep trouble in America. The financial crisis has inflicted hardship on a population that does not like to face harsh reality. President Obama has deployed the “confidence multiplier” and claims to have contained the recession. If there is a double dip the population will become susceptible to all kinds of fear mongering and populist demagoguery. If President Obama fails, the next administration will be sorely tempted to create

some diversion from troubles at home and that could be very dangerous to the world.

President Obama has the right vision, but he needs to be more far-sighted. He believes in international cooperation rather than the Bush-Cheney idea of might is right. But he is preoccupied with many pressing problems. Reinventing the international financial system is not high on his agenda. Some of his economic advisers still seem to believe that the efficient market hypothesis is valid, except once in a hundred years. The financial institutions that have survived are in a stronger competitive position than ever before and they will resist a systematic overhaul that would curb their powers. What is lacking is a general recognition that the system is broken and needs to be reinvented. That is why it would be so important that the theory of financial markets I have outlined in these lectures should gain wider acceptance.

The Chinese leadership would need to be even more far-sighted than President Obama. They are in the driver's seat and if they moved towards a more open society they would have to give up some of their privileges. Right now, the Chinese public is willing to subordinate individual freedom to political stability and economic advancement, but that may not continue indefinitely. Corruption is a big problem and China needs the rule of law so that citizens can criticize the government and prevent it from abusing its powers.

And China needs to become a more open society in order to be acceptable to the rest of the world. The rest of the world will never subordinate the freedom of

the individual to the prosperity of the Chinese state. As China is becoming a world leader, it must learn to pay more attention to the opinion of the rest of the world. But all this may be happening too fast for the Chinese leadership to adjust to it. China is too accustomed to thinking of itself as the victim of imperialism to realize that it is beginning to occupy an imperialistic position. That is why it has such difficulties in dealing with Africa and its own ethnic minorities. Hopefully, the Chinese leadership will rise to the occasion. It is no exaggeration to say that the future of the world depends on it.

Thank you.