**This op.ed. appeared (in respective language translations) in :**

**Handelsblatt (A leading newspaper in Germany, 22nd September, 2009)**
**NZZ am Sonntag (A lading Swiss Newspaper, 29th September, 2009**
**Il Riformista (A leading Political Newspaper in Italy, 28th September, 2009 Front page)**
**Business Standard (A leading Indian Financial/Economic Newspaper, September 2009, in two parts)**

# THE CRITIQUES OF CAPITLAISM AFTER THE CRISIS: MYTHS AND FALLACIES

**BY**

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**When the twin crises erupted on Wall Street and Main Street, each fierce in itself but jointly interactive and ever more frightening, the populists rushed forward to celebrate the Demise of Capitalism and to plunge their pitchforks for added gratification into the dead corpse. They have had their champagne parties. By now, the fizz is gone, however, and we are left with tattered myths and egregious fallacies that invite scrutiny and refutation.**

**Myth # 1: <u>The Crisis is a Defining Moment like the Collapse of the Berlin Wall</u>**

**I can do not better than begin by citing a prominent economist today, who would like to drive a stake through Capitalism and Globalization (which is viewed, not without some justification, as an international extension of Capitalism since it is hard to imagine a robust economic globalization without Capitalism being at the bottom of it).**

**This is none other than my Columbia colleague Joe Stiglitz. He made a much-cited claim that the current crisis was for capitalism (and markets) the equivalent of the collapse of the Berlin Wall. Now, we know that all analogies are imperfect. But this one is particularly fatuous.**

**When the Berlin Wall collapsed, we saw the intellectual bankruptcy of both the authoritarian politics of communism and the economics of extensive, almost universal, ownership of the means of production and of central planning. We saw a wasteland.**

**But, when Wall Street and Main Street were shaken by crisis, we were witness to a pause in prosperity, not an end to devastation. We had enjoyed almost**

**two decades where the liberal reforms undertaken by nearly half the world's population, in China and India, had produced unprecedented prosperity and, this must be emphasized, had finally made a significant impact on poverty as well, just as we reformers had asserted.**

**The rich countries, with a steady expansion of liberal policies during the 1950s and 1960s, had also registered substantial prosperity, to be interrupted by exogenous circumstances like the success of the OPEC in 1971 and the Volcker-led purging of the consequences in the 1980s, but with general resumption of robust growth thereafter. Besides, an increasing number of the poor countries had turned to democracy, starting from a situation where India had been the "exceptional nation" to have embraced and retained democracy after Independence.**

**But then some critics shift ground, claiming that higher growth is beside the point: we need to judge capitalism by whether it works for the poor. But, slowly-growing or stagnant economies cannot rescue the poor from their poverty on a sustained basis. In countries with massive poverty such as India and China, the principal solution had to be provided by rapid growth of incomes and jobs. This is, of course, commonsense: just as firms that make losses cannot finance Corporate Social Responsibility, countries with stagnant economic performance cannot rescue people from their poverty. This "growth strategy" to address poverty has therefore been described by me as a radical, activist "pull up" strategy, not a conservative, passive "trickle down" strategy .**

**After the liberal economic reforms, they did register accelerated growth rates; and finally this did pull up nearly 500 million above the poverty line during**

**the last twenty years. However grim the current crisis has been, it cannot be used to deny and destroy this elemental truth.**

**But has the fate of the poor in the rich countries been less comforting? The labor unions such as the AFL-CIO in the US are convinced that trade with the poor countries has produced paupers in the rich countries by depressing real wages. But this dire conclusion is unsupported by empirical analysis. My own analysis, dating back at least a decade (and extended in my 2004 Oxford book, <u>In Defense of Globalization)</u>, argued that, if anything, the fall in wages which labor-saving technical change and other domestic institutional factors would have brought about, had been moderated by trade with the poor countries. This benign conclusion has been re-asserted by Robert Lawrence of Harvard's Kennedy School for recent years,**

**So, neither for overall prosperity nor for effects on poverty in the poor countries and the wages of the poor in the rich countries, we have reason to be apologetic for what liberal policies and reforms accomplished. To compare the interruption of this remarkable record to the collapse of the Berlin Wall therefore is like drawing a parallel between a terrifying tsunami and a monsoon that has brought rain and a rich harvest to parched plains.**

**<u>Myth #2: The End of Market Fundamentalism</u>**

**But the critics also argue that the crisis spells the end of "market fundamentalism". But the presumption from which these critics start is that we were in the pragmatic center and have moved to the market fundamentalist right, letting markets rip and rip us apart. But this is totally wrong for much of the world,**

**certainly for the developing countries. Many of the developing countries had been into "anti-market fundamentalism" such that there was extreme hostility towards markets and much knee-jerk interventionism such that Adam Smith's Invisible Hand was nowhere to be seen. When they realized that this model was not working and had cost them dearly, they moved to the pragmatic center. So, the reality is that we shifted in recent years, not from pragmatism to market fundamentalism as Stiglitz and Soros would have us believe, but from anti-market fundamentalism to the center.**

**<u>Myth #3:</u> <u>The End of "Washington Consensus</u>"**

**A related myth is the notion that somehow there was a Consensus in Washington, in the Bretton Woods institutions, that had driven the world into liberal reforms that included market fundamentalism. But anyone familiar with the economic reforms that were undertaken with gusto in Soviet Union (and then Russia), in India, and in China, which add up to a gigantic share of the world population, has to know that these were endogenous.**

**The reformers in all these countries were driven by their increased awareness that, without these reforms, they would continue to stagnate. The Russian expert Padma Desai has written how Gorbachev and Shevardnadze finally decided that, without reforms, Soviet decline would continue to get worse and a super-power would be reduced to a super-beggar in world politics.**

**None of these reformers cared however what Bretton Woods institutions, or Washington more generally, thought and felt. Washington Consensus is therefore little more than Washington Conceit, spread by Western media at first and then by**

**the anti-market fundamentalists and the anti-globalists who find that the phrase, and the anti-Americanism which it invokes, gets them greater mileage than the content of their critique actually merits.**

**Myth #4: Markets Undermine Morality**

**Inevitably, the crisis on Wall Street has revived the notion that markets undermine morality. Oliver Stone, ever restless to recapture the days of former glory, is, we're told, contemplating a sequel to the 1987 movie Wall Street which immortalized Gordon Gekko as the symbol of markets and greed. These critics believe that working with and within markets fuels our pursuit of self-interest, greed, avarice, self-love in ascending orders of moral turpitude.**

**But this assertion is surely at variance with what we know about ourselves. Yes, markets will influence values. But, far more important, the values which we develop in several ways will affect how we behave in the marketplace. Consider just the fact that different cultures exhibit different forms of Capitalism. The Dutch burghers Simon Schama wrote about in The Embarrassment of Riches used their wealth to address the embarrassment of poverty. They and the Jains of Gujerat from whom Mahatma Gandhi surely drew inspiration, and the followers of John Calvin, were all exhibiting values that came from religion and culture to bring morality to the market.**

**Again, the economist Andre Sapir of Brussels in particular, has pointed out the diverse forms of capitalism that flourish in the world, denying the claim that markets wholly determine what we value. Thus, the Scandinavians have an**

**egalitarian approach to their capitalism which differs from what we find in the United States where equality of access, rather than of success, is the norm.**

**How does one react then to the Madoffs? Do they not represent the corrosion of moral values in the market place? Not quite. The payoffs from cutting corners, indeed outright theft, have been so huge in the financial sector that those who are crooked are naturally drawn to this sector. It is not the financial markets that have produced Madoff's crookedness; Madoff was almost certainly depraved to begin with.**

## Myth 5 # The Financial Collapse Reflected Ideology

**Yet another myth , at least in the financial sector where the collapse began, is that the crisis had been driven predominantly by the ideology of markets and deregulation, rather than by factors such as lobbying by Wall Street to make profit.**

**1. Unwarranted Extrapolation: Of course, the notion that a freer play for financial markets, and indeed increased reliance on self-regulation, would produce the greater good, played a role. The postwar period had shown that the power of liberal economic policies on trade and direct foreign investment. But to carry over the legitimate approbation of freer trade in particular to the altogether more volatile financial sector, which represents the soft underbelly of capitalism was surely unwarranted.**

**The East Asian crisis in 1998 had been a result of this unwarranted extrapolation from free trade, resulting in freed international capital flows. But a simple analogy illustrates the asymmetry well. If I exchange some toothbrushes for**

**some of your toothpaste, and we both remember to brush our teeth, our teeth will be whiter and the chance of our teeth being knocked out in the process is negligible. But with capital flows, the proper analogy is to fire. It enables Tarzan to roast his kill in the jungle but it can also burn down Lord Greystoke's manor in England.**

**2. Wall Street-Treasury Complex: But we must ask why some of the world's best economists such as Larry Summers went along with this illegitimate extension of the indisputable advantages of markets in trade to the financial sector, when in fact they could not but have been aware of the asymmetry I had written about. For this, my explanation was what I called in my 1998 Foreign Affairs article, and in several writings subsequently, the Wall-Street Treasury Complex. With the constant to-and-from movement of people like Robert Rubin and lesser but still influential figures between Wall Street and Treasury, the euphoria about how markets, which would serve the interests of Wall Street, would function as well in the financial sector as in trade was shared by people wearing the same Brooks Brothers suits and belonging to the same clubs and circuits. It therefore led to a suspension of guard by these gifted economists in the Treasury, and by their high-level counterparts in the International Monetary Fund which also joined in the chorus for freeing up capital flows.**

**3. Lobbying: One of the dramatic moves that played a role in the crisis was when the heads of the big five investment banks, among them Treasury Secretary Hank Paulson who was then CEO of Goldman Sachs, "persuaded" SEC to impose no reserve requirements on their lending, resulting in reckless over-leveraging that accentuated the crisis when the housing bubble burst and securitized mortgages**

**became toxic assets. But this had to do with lobbying for profit, not with ideology. Hank Paulson was a graduate of Dartmouth, a famously liberal arts College; and he was known to be an ardent environmentalist. He was no ideologue on markets.**

**4. <u>Government Failures</u>: But why did the SEC agree to this demand? This had to do with governmental failure, for sure. Senator Schumer who represents New York and therefore has Wall Street PAC contributors, is known for having indulged in Japan-bashing, then India-bashing, and now China-bashing: all because he was playing for his constituents. This time around, he bought into their argument that Wall Street would lose to London if the demands of the investment banks were not conceded. So, he played a crucial role in the "race to the bottom" that was central to the crisis.**

**In addition, governmental role in the crisis was evident in the way in which Congressmen of both parties bought into the argument that everyone, regardless of their circumstance, must own a home, thus encouraging profligate spread of sub-prime mortgages that fed the housing bubble with what would become toxic assets. The US, instead of becoming a house-owning democracy, bought into a certain crash that would imperil the economy.**

**4. "<u>Destructive Creation" in Financial Innovation versus "Creative Destruction" in Non-Financial Innovation</u>**

**The packaging of these sub-prime mortgages into collateralized debt obligations (mortgage-backed securities, MBS) was married into the invention of credit default swaps (CDS) by J. P. Morgan bankers who got third parties like AIG to assume the risk of default on these securities in exchange for regular payments resembling an insurance premium. The MBS was expanded massively because it**

**was assumed that the risk of default in the underlying mortgages was less because everyone would not default together, not allowing for the tsunami that hit when the housing bubble burst and the sub-prime mortgages collapsed together. The associated massive exposure by those issuing CDS, which had been done without setting aside adequate reserves to guard against such a tsunami, meant that the collapse of the financial sector was guaranteed.**

**In short, few on Wall Street, caught up in the euphoria over these financial innovations, had allowed for the fact that financial innovation had potential downsides which were huge and had to be carefully thought through and guarded against. We were confronted by the fact that, while non-financial innovation such as the invention of the PC would require what Schumpeter called "creative destruction" so that Olivetti and IBM which produced now-obsolete typewriters would be eased out, in the case of financial innovation, the invention of new instruments had a wholly different downside possibility which could make it into what I, and journalists such as Gillian Tett and Thomas Friedman since then, have called "destructive creation".**

**Innovation in the financial sector therefore has to be dealt with differently from other innovation. I have therefore argued that we need an independent set of experts, who are familiar with Wall Street but are not part of it and the Wall Street-Treasury Complex, to evaluate the downside of new instruments and to make that informed analysis available to regulators. Regulators, after all, cannot regulate what they cannot understand. True, no one can foresee everything. As Keynes remarked characteristically in a letter to Kingsley Martin, the editor of The New Statesman,**

**"the inevitable never happens; it is always the unexpected". But the Committee which I have proposed, and which is in different versions part of the new financial regulatory architecture now being discussed, should be able to narrow the range of the unexpected.**

**Clearly, the crisis demonstrates that the financial sector which provides the life blood of capitalism --- without the blood flow, the best muscles in the world will not survive --- needs carefully designed, not knee-jerk, correctives, as indeed is widely recognized. Nor does it condemn capitalism to the dustbins of history as the critics would hope for.**