Edited Version Appeared in **September 2009**
World Affairs Journal (October 2009)

[Somewhat shorter versions have appeared around the world in September 2009 in leading newspapers such as Handelsblatt]

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 populist today, an icon to the "madding crowd" 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 who shared the Nobel Prize in Economics with the remarkable George Akerlof of Berkeley who was the pioneer of the subject of asymmetric information with his brilliant paper on "the market for lemons" which was the first to draw on the insight that the sellers of used cars (i.e. lemons) had more information than the buyers and hence this would generally lead to "market failure". In the long sweep of market failures, with virtually every generation since Adam Smith focusing on a different one appropriate to its time, asymmetric information is just one more, of course; and it is not even among the most important ones, one could argue. But Stiglitz made instead 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.

Some will object that economies have at times registered high growth rates for long periods despite bad economic policies. But we must ask: are these growth rates sustainable? I tell the story about how my radical Cambridge teacher, Joan Robinson, was once observed agreeing with the mainstream Yale developmental

economist Gus Ranis on Korea's phenomenal growth. The paradox was resolved when it turned out that she was talking about North Korea and he about South Korea. Now, more than three decades later, we know who was right. In a similar vein, Soviet growth rates were high for a long period, thanks to exceptionally high investment rates, despite the horrendous absence of incentives and embrace of autarky. But then, the Soviet Union descended into steadily declining growth rates until a mismanaged transition with <u>perestroika</u> which plunged the country into negative growth rates.

The effort to make the anomalous into the universal is a polemical exercise. Economists such as Dani Rodrik who like to cite occasional high growth rates in countries despite the absence of liberal (or "neoliberal" which sounds more sinister and is therefore the preferred epithet) policies as a refutation of the desirability of such policies miss the point and miss the sweep of history as well.

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 as illustrated by an engraving where an English

feudal lord and his vassals are drinking wine from goblets and feasting on legs of lamb and venison, with crumbs falling to the dogs and serfs below the overflowing table.

The problem was that, with bad policies, China and India failed to grow in the first place. 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, despite an unsuccessful attempt by Paul Krugman in a recent Brookings paper, commissioned by Larry Summers, to prove otherwise. Indeed, the same goes for the effect of unskilled immigration (mostly illegal across the Rio Grande) on the wages of our unskilled workers. Giovanni Peri of University of California at San Diego has shown for unskilled immigration what I did for trade with poor countries: that the effect is benign, not malign.

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 to 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, who include Stiglitz and, ironically, George Soros who has done well by working the markets, also argue that the Crisis spells the end of "market fundamentalism". My Swedish friend Leif Pagrotsky, who was in the cabinet in Prime Minister Persson's government and is on the left in the Social Democratic Party, told me with amused astonishment that, at a Panel meeting at Columbia University in New York, Soros had accused him of "market fundamentalism": a phrase that has now become the M-word of scorn in these fringe populist circles much like the L-word among the fringe rightwing circles.

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.

Myth #3: The End of "Washington Consensus"

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 precise mix of politics, institutions and history did matter in the specific trajectory of reforms chosen. In my Radhakrishnan Lectures at Oxford in 1993 (published by Clarendon Press as India in Transition), for instance, I discussed the factors driving Indian reforms which began in earnest in 1991 with the current Prime Minister leading the way as Finance Minister at the time. These included the fact that the reforms became inevitable as the dissonance grew between the Indian superiority complex about its "ancient culture" and the "inferior status" that her sorry economic performance entailed. 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 witless 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 and stokes, 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. and perhaps the indefatigable Steven Spielberg, a victim of Bernard Madoff's skullduggery, will make a blockbuster on the sorry episode.

Of course, the evergreen debate on what markets do to morality has not always been a slam dunk for the anti-market critics. While Matthew Arnold, especially in his influential 1868 book, Culture and Anarchy, was most spectacularly among the critics, Voltaire's passionate defense of markets, most eloquently in his Philosophical Letters in 1734, made him the most influential hero of the new age of the bourgeoisie. Peace and social harmony, as against religious strife common until then, would flow from the secular religion of the marketplace.

In this fascinating debate on a broad canvas over two and a half centuries, my sympathies lie with those who have found markets on balance on the side of the angels. But I should also add that I find the specific notion that markets corrupt our morals, and determine whether we behave ethically, to be a vulgar quasi-Marxist notion, that where we work is critical to our moral destiny, just as Marxists believe that the ownership of the means of production is critical to our economic destiny. The notion that working with and within markets fuels our pursuit of self-interest, greed, avarice, self-love in ascending orders of moral turpitude, 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 <u>The Embarrassment of Riches</u> 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, many, and most noticeably the economist Andre Sapir of Brussels, have noticed the diverse forms of capitalism that flourish in the world, denying the claim that markets 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. I was reminded of this when last year I spoke at the Nordic Prime Ministers' Conference

in Riksgransen in Lapland, on the northern frontier with Norway, where the temperature was way below anything that I had experienced since I left India for cooler climates; and where, heavily padded against the deep freeze and recovering from a knee replacement surgery, I was moving around one jerky step after another through the slippery ice like the Abominable Snowman . I shared the platform with the Swedish Prime Minister, and earned the applause of my audience when I remarked that I was impressed that the five Prime Ministers had traveled nearly 25 miles from the airport at Kiruna to Riksgransen in the same bus as myself and others; and that, if the Swedish King had been invited, he would have been on his bicycle behind the bus.

So, where do we get our values from? They come from our families, from our communities, from our schools, from our churches, and indeed from literature. Let me emphasize the importance of great literature whose role is increasingly lost to view as blogs (which I call flogs) have steadily undermined serious writing, and celebrity sensationalism and PR have gained ground in the media. My own exposure to the conflicts of absolute values came initially from reading Dostoevsky's <u>Crime and Punishment</u>, where Sofya Semyonovna Marmeladov (Sonia) turns to prostitution to support her family. The love of the environment came from reading Kawabata's famous novel, <u>The Old Capital</u>, which reflects harmony between man and nature, rather than the traditional Christian view that nature must be in the service of man.

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. If you operated in agriculture, you would have to work hard through financial contributions to the politicians who make policy on agricultural subsidies: but what you would gain is a pittance compared to what you could make in one fell swoop, week after week, in the financial sector. The manufacturing sector offers rewards that lie in between; but even the moneys made by the CEOs of firms like Enron are small potatoes compared to what a George Soros or a Pete Peterson could, and did, make in the financial sector. So, if you are a crook, you gravitate towards the financial sector. It is not the financial markets that have produced Madoff's crookedness; Madoff was almost certainly depraved to begin with.

Of course, given the same propensity to sin, greater payoffs from sinning could also lead to greater incidence of fall from virtue. So, in this case, the financial sector corrupts morality in the sense that the existence of a call service tempted Governor Spitzer into otherwise-repressed licentious behavior. Should we blame the Governor's transgressions on the call service rather than on his own tragic flaws?

Myth 5 # The Financial Collapse Reflected Ideology Rather than Factors like Lobbying

But something more needs to be said about the notion that, at least in the financial sector where the collapse began, the ideology of markets and deregulation had driven the crisis, rather than by factors such as lobbying by Wall Street to make profit. But that is too simplistic and therefore wrong.

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 indeed shown, as recalled above, 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 pressure from the IMF and the US Treasury on developing countries to embrace capital account convertibility (i.e. free capital flows, so you could walk into a bank and convert as much domestic currency into foreign currencies of choice) was palpable and was indeed a principal cause of the East Asian financial crisis in the late 1990s. At the time, I wrote of the asymmetry between free trade and free capital flows in Foreign Affairs (1998), titled provocatively as "The Capital Myth" by then Managing Editor Fareed Zakaria. I became an instant celebrity since even sophisticated intellectuals like Eric Hobsbawm (who cited approvingly my "heresy") assumed mistakenly that if you were for free trade, you had to be for free 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: Euphoria, Not Ideology: 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 the 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.

It was interesting that the noted Berkeley economic historian, Brad deLong, who writes today a fiercely angry liberal blog, was among the most impassioned defenders of the assertion that free capital flows would generate gigantic benefits and was among the most vocal critics of my views: the euphoria had clearly spread beyond the most prominent members of the Wall Street-Treasury Complex.

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 securitised 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, the way Alan Greenspan, the Ayn Rand aficionado, was; he would have shrugged his shoulders in disdain if asked to read her!

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.

The Columbia Law School Professor Harvey Goldschmid, who served as an SEC Commissioner, has talked about the plethora of mortgages, at both these institutions and private banks, by unscrupulous, unqualified mortgage agents whose

peddling of mortgages to unsuspecting clients largely replaced the conventional, careful evaluation of servicing ability of those seeking mortgages by small bankers: it was as if you were flying in planes flown by untrained pilots and owned by profit-seeking airlines which lured in flyers who could barely afford an old jalopy.

4. "Destructive Creation" in Financial Innovation versus "Creative Destruction" in Non-Financial Innovation

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 which 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".

This had also been true of the earlier development of derivatives that had been at the heart of the Long Term Capital Management (LTCM) crisis of 1998. I was told that the Bank of International Settlements, an important institution overseeing the financial sector in the world economy, had convened a conference in Basle of high-level central and commercial bankers, soon after the LTCM crisis and Rescue; and most did not know what a derivative was!

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.

Myth 6# Fixing Capitalism will require Invasive Surgey

Need I argue further that the notion that capitalism as a system has collapsed and requires invasive surgery is far from compelling? But one observation must be made regarding what exactly needs to be done to strengthen capitalism today.

Capitalism works best when those who do not succeed and are buffeted by the vicissitudes of life feel that those who work out well instead are not using their wealth to indulge themselves but are putting their wealth to good use. Remember that Jains and Calvinists accumulated wealth but spent it, not on themselves but on promoting social good.

Alternatively, capitalism works well when those who lose believe that social and economic mobility is such that those who lose feel that one day they could also win. This is the great "American myth": even when the mobility has been less real than imagined, what Americans believe is what matters.

Today, in the United States, both "stabilizers" of capitalism have taken a hit. There has been far too much flaunting of wealth, even as the working class incomes have stagnated, with magazines on "How to Spend It" in the Financial Times and displays of the insufferably rich glitterati in the Styles section of the New York Times being among the leading examples of a compliant and complacent, profit-seeking media giving such displays wider circulation even as they occasionally condemn the Return of the Gilded Age.

Raw nerves were hit also when, in the manufacturing sector, many CEOs were seen getting out with encashed stock options as their firms were failing (a fact

that they knew about but not their workers and shareholders), leaving the workers and shareholders with defunct stock options and stock. I believe that the condemnatory reaction arose, not from the sums involved and notions of "justice" and "fairness", but from the fact that this phenomenon deeply offended the cultural and ethical sensibilities of Americans. After all, they are brought up on the notion that a captain stands at salute on the sinking ship while the passengers get out in lifeboats. Instead, we had CEOs leaving in lifeboats and the workers and others were left to sink with the ship.

The concern with high pay is not an answer. American society after all works with extreme inequality in pay --- College Presidents, the few critics of capitalism on campuses and on Wall Street, media anchors, in fact virtually everyone enjoys salaries and emoluments which appear outrageous to someone or the other. In India, when we espoused socialism, the cynical definition of outlawed luxury was goods that the socialists did not (presently) consume. Once I was at a Planning Commission seminar and a socialist planner said we should not spend scarce foreign exchange on importing lipstick. Instead of arguing the economics of what he had said, I simply said that, even as he was saying this, I could smell the imported Brylcreem in his hair!

Rather, we need to take a different turn. Bill Gates and Warren Buffet are splendid examples of great family fortunes made within capitalism but put to social use, making the capitalism they signify appear more palatable. When we get modern corporations doing this, we call it Corporate Social Responsibility. More of this will clearly have to be done: the comforting thought is that many who make

millions rather than billions, have also turned to charitable giving. So have College students whose altruistic concerns are now so manifest that, while President Kennedy gave the lead through Peace Corps in harnessing their desire to give of themselves, President Obama can only follow with approbation of their generosity.

But we also need to respond to the steady erosion of the American myth of mobility which led Harlem residents believe that when Soros doubled his fortune in the markets, that was not cause for resentment and incipient revolution but that, given their belief in mobility, this only meant that the size of the lotto had gone up! Today, after nearly a quarter century of wage stagnation, and growing evidence that educational access has also declined for the poor, that myth of mobility is eroding, however slowly.

We have to respond by improving educational access and by relieving anxiety by medical reforms that make health part of a basic provision for the poor. These reforms are part of strengthening capitalism; without them, the populists will enjoy political success that they do not deserve.