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The Fallacy of the "Free Market" and the Future of Globalization

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What is the right balance between the market and the state in governing the economy? Should we have bailed out the banks? What do we learn from the history of capitalism in the 20th century, and what are the prospects for the future of globalization? Does the rise of the BRICs mark a fundamental change in the global political economy? These are vital questions for our time.

1. The Fallacy of the "Free Market"

As Yogi Berra famously quipped, "It's like deja vu all over again." And so it is with discussions about the appropriate balance between the market and the state as a means of guiding the economy. A bit of history would be useful here. If we stick just to this past century (by which I mean, the early 20th, to the early 21st), we've had two huge swings of the pendulum already, and are, possibly, in the midst of a third, although it's still too early to tell for sure.

But ... before getting to that, let's dispose of one canard. You'll notice I said that what's at issue is the appropriate balance between the market and the state. That logically presupposes that the market and the state are both involved in governing the economy. Indeed, they are, joined at the hip, like Siamese twins, although sometimes in denial of that fact. In some popular discussion of the issue, it's framed as one of whether it's the "free market" or the government that should control the economy. That's a fundamentally

wrongheaded, and ideologically driven, way to see matters -- whether you are a free market ideologue or knee-jerk anti-capitalist.

For one thing, when people who advocate it talk about a "free market", what they really mean is a market with minimal but vitally important government involvement, in particular, to protect property rights, enforce contracts, furnish fair and impartial courts and police, and generally set the rules of the game, so that, within those rules, folks can trade freely and without the fear of coercion. (After all, if a hooligan puts a gun to your head and forces you to trade with him, it's not really free. And the doctrine of the gains from trade in economics is premised on mutual, voluntary cooperation. The exceptions have to have some bite, else the doctrine degenerates into a tautology.)

That's a far cry from a "free" market. A truly free market, with no government intervention, would rather be the sort of thing you'd find in a Hobbesian state of nature. People in such a world would be so busy defending themselves and their stuff, and trying to stay alive and fend off attacks from their neighbours, that they wouldn't have time to trade much in anything, and the market would be pretty primitive. Life would be, to coin a phrase, poor, nasty, brutish, and short.

I spend time on what seems like a minor semantic point, because, well, it's not really that minor. Words do matter, and there's an Orwellian sense in which the proponents of minimal government, low taxes, and so forth, use the term "free market" to capture their point of view, trading on the emotive and hortatory appeal of the concept of freedom. Whether this is driven by ideological fervour, or just by intellectual laziness and the inability to be precise, I'm not sure. But there's a subtler and equally important reason, which is the way that economics is taught nowadays, and for the last while: the last sixty years or so, at any rate, since Paul Samuelson's *Foundations of Economic Analysis* and the later Arrow/Debreu theorem on the existence of a competitive market equilibrium.

As academic economists, we teach our students based on stylized mathematical and statistical models devoid of any institutional detail or richness. Take the textbook microeconomic model of the competitive market, whether of the sophisticated Arrow/Debreu (general equilibrium) or plain vanilla Marshallian (partial equilibrium) variety. In either case, the price system operates to get us to the equilibrium, without having to worry about niceties like property rights and contracts being enforced. The closest thing to an institution is the fiction of the Walrasian auctioneer, a *deus ex machina* who gets rid of excess demand by raising the price and excess supply by lowering it.

So it's very easy to slip into a mode of thinking that the market functions on its own, when one conceives of the economy purely based on these stylized models. Thinking of the market as an equilibrium condition in a system of equations makes you forget that a real market, whether physical or electronic, can only exist in an institutional system of rules, and this, to work well, must be governed by an agent who stands above the market, which we call, for convenience, the state.

Now, here's the irony. The point above is well known, and was made many times by libertarians such as Friedrich von Hayek, who was suspicious of mathematical and statistical modelling of the economy (whether of the classical or Keynesian varieties). To him, it was a slippery slope from a model to the dogma of scientific socialism, the notion that the economy is a machine that can be fine tuned and managed, and therefore ought to be, by a benevolent central planner on behalf of the social good. He correctly predicted that the Soviet system, based on state control over everything, with no markets to speak of, and backed up by state coercion in the absence of personal liberties, wouldn't work.

In other words, the context in which the state and the market intersected was vitally important, and, for Hayek and those of his ilk, that had to be a

liberal society. But yet it's now often the folks on the libertarian end of the spectrum who forget this point, and imagine somehow that the economy can be detached from the rest of society, and the state, in which it's embedded, when they engage in discussions of the "free market". Let's henceforth banish this term, and talk if we wish of a "minimally regulated market". It's less sexy, but more realistic, and will keep us honest about what's involved.

2. Moral Hazard, the Volatility of Capitalism, and Socialist Revolution: Why Hayek and Lenin Would Oppose the Bank and Auto Sector Bailouts

Ironies and role reversals multiply when you consider reactions to the bailout of banks and the auto industry after the global financial crisis. The largely unarticulated positions of the left and right coincide in disagreeing with the bailouts, while centrist, reformist opinion has been largely supportive, at any rate acquiescing through silence. The standard defence for bailing out (say) banks who've messed up and, therefore, should presumably have to pay for their mistakes is that the consequences of not doing so would be worse. So, even if we don't like those fat cat bankers who've gotten us into this mess, we have to hold our nose and help them out, and hope they don't get into the same or a bigger mess again.

The various critiques of bailing out the banks, in particular, usually boil down to some version or the other of what economists call the moral hazard problem: that is, bailing out someone who has behaved recklessly will make him more likely to be reckless in the future, because he knows that you're going to bail him out again. It's a species of economic problem that occurs when information is imperfect, or, to be more precise, asymmetric. Moral hazard is a problem of hidden action; the other classic such problem, adverse selection, occurs when there is hidden information. Both were probably at play in the case of the banks, but let's stick to moral hazard for the moment.

Here is the simplest example of moral hazard, that I always use on my college freshmen (and which appeals to them, for some strange reason): If every time you go to the casino, and you win money, you keep it, but, when you lose, your parents pay off your markers, will you be more or less likely to gamble more recklessly next time you go?

Now, there's another version of this critique, which the gambling example fits as well, which says that bailing out bad banks (but not taxing them heavily when they make fat profits) is "privatizing profits" and "socializing losses". This sort of behaviour would tend to exacerbate the moral hazard problem, as with my freshmen gamblers.

But all of this elides, or rather scants, the more radical critique of such bailouts, that, ironically enough, comes from both left and right, although, of course, with somewhat different rationales. Let me sketch this out for you.

Someone on the right, a full-blooded libertarian who's a follower of Hayek or Milton Friedman, would say that it's the nature of capitalism to be inherently volatile. Tampering with this inherent volatility of the capitalist system, trying to attenuate it, is a bad idea, because it dampens the creative entrepreneurial juices that keep capitalism vibrant and gives us ongoing technological advance and higher economic growth in the long run. (This relates to an older debate, to which Nick Rowe and I have contributed, on whether business cycles are good or bad for growth: the classical view is that they are good, as they are a time of "cleansing" or a "pit stop" for the economy.) Don't forget that Hayek opposed any government intervention during the Great Depression itself. He would surely be opposed to the recent bailout packages.

One should be careful at this point to distinguish bailing out the banks versus other affected sectors of the economy, such as the auto industry. It is the peculiar nature of banking that makes completely private sector banking with no or minimal government regulation inherently fragile and excessively

volatile, because of the possibility of bank runs, for instance, which is why governments have figured out that they need to serve as a lender of last resort to banks. In other words, Hayek probably wouldn't have liked the status quo much either, and so the question is moot, perhaps, on what he would have thought of bailing out the banks.

But for a "normal" industry, say the auto industry, the argument is much more clear-cut. The big three US automakers, and their Canadian subsidiaries, clearly didn't adapt to the changing economy, and got stuck in a mode where they made big gas-guzzling cars, and cut deals with the unions in which they essentially shared monopoly rents with them. That would account for the ten paid spa days, apparently, that every auto worker at GM was entitled to in the good old days. I don't think I need to convince you that the automakers, quite simply, dropped the ball, and so it is a fair question to ask, a la Hayek, why we should be expected to bail them out. If we do, we'll just subsidize their inefficiency, and prevent them from going bankrupt and being replaced by something more efficient. Or maybe we should just stop producing autos altogether in North America and import them from China, Korea, India, and Brazil, where they're cheaper to make? Comparative advantage would suggest that.

So much then for the critique from the right. How about the folks on the left? Take Lenin, who was a contemporary of Hayek. He would agree, up to a point: Yes, capitalism is inherently volatile, and the market, left to itself, will tend to go to excesses of one sort or another. But -- here's the big difference with the reformist centrist -- he would surely have opposed succour to the wounded bulls of Wall Street. Because it's only when capitalism gets into a major crisis that the socialist revolution that's meant to sweep it away will occur. And you can't have a socialist revolution if you keep intervening to save capitalism from itself. This critique applies, of course, to stimulus packages as much as to bank and auto sector bailouts.

Now I don't think anyone, at least in the mainstream media, had the courage to articulate the radical left critique of the bailout and stimulus packages, being contented to bleat that it just bails out the fat cats on Wall Street and is unfair to Main Street. Here, I think there's something of a reversal of roles, and the right, for once, is taking an intellectually more honest approach in articulating its objections to the bailouts: yet another ongoing chapter in the saga of the market and the state.

3. A Short History of the 20th Century

Of course, the real debate is not about the market versus the state, but the more nuanced one, of what sort of rules of the game the government should set, so that the market can do what it does best, both for itself and for society, while the state takes care of the rest. The last bit is the tricky part, since this takes us into debates about the possible tradeoffs between efficiency and fairness, in particular, equity. It's possible to pick different points on this menu of choices, from the Anglo-American model (minimal government, maximal market) at one end of the spectrum to the Scandinavian (minimal market, maximal government) at the other, sticking just to Western liberal democracies which are in other respects largely similar culturally.

That's the crux of the debate between so-called "liberals" and "conservatives", in American argot, or what would be called "social democrats" and "liberals" in Europe. (Their "liberals" are "conservatives" in American usage, which can get confusing.) Before we can understand this latter debate, we need to get our history straight. That old one of knowing one's history or being condemned to repeat it comes to mind.

If we look back exactly a hundred years ago, there was a general consensus on the minimal government, maximal market, view, that is associated with today's free marketeers. Trade barriers were low, goods and capital flowed freely, there was monetary stability provided by the gold standard, and,

quite different from today's globalization, immigration barriers were low. People more or less went and settled where they wanted without the need for passports and elaborate border controls. New technologies such as the automobile, the airplane, the telephone, and the radio were breaking down barriers and bringing people closer together. Replace telephone and radio with cellphone and the internet, and it's not so different from today.

Well, there was one big difference, a huge one actually, that all this good stuff was happening mostly for people living in Europe and North America, and most of the rest of the world remained in the grip of imperialism and colonization, and so missed the boat on economic development. But that huge subject is one for another time. Let's keep our Eurocentric perspective for the moment.

With our futuristic glorification of technology today, and our short memory, we often forget that, in this earlier era of globalization, the world was, in many ways, more globalized than it is even today. Throughout recorded human history, news travelled around the world excruciatingly slowly, at the rate of the fastest runner, horse, carriage, steamship or train, whatever the technology of the time. With the invention of the telegraph, the time it took a message to, say, cross the Atlantic, was cut from a few weeks to a few minutes, and, with the invention of the radio and the telephone, to a few seconds. This is far greater in magnitude than anything we have accomplished since: the internet, for example, has cut that transmission time only marginally, to a fraction of a second.

As we all know, this first globalization came crashing down with the outbreak of the First World War, and the confusion of the interwar years. Thanks to the Russian Revolution, revolutionary socialism, of the Marxist-Leninist variety, seemed at the time to be a viable alternative to liberal democracy. The Great Depression sealed the deal. There was a general disillusionment and loss of faith in the market economy, and that led to the first big swing of the pendulum. Through the New Deal, and similar programmes elsewhere,

the balance in the equation tipped towards markets being reigned in, and more government intervention in, and regulation of, the economy. One facet of this new scenario was the Keynesian revolution in macroeconomics: it was felt that governments could, and ought to, eliminate, or at any rate attenuate, fluctuations in the business cycle, so that something like the Great Depression couldn't happen again.

Another facet was to impose a set of new regulations on banks and other industries to ensure that the reckless speculation that caused the stock market crash in 1929 that tipped the world into the Great Depression couldn't happen again. And yet another facet was increased cooperation amongst governments to ensure, for instance, that beggar-thy-neighbour trade policies wouldn't be used again, as they were, with disastrous effects, during the Depression (America's infamous Smoot-Hawley tariff and copycats elsewhere), hence the creation of new international organizations such as the Bretton Woods twins (the World Bank and IMF), and the GATT, now the WTO.

All of these developments led to what has come to be known as the golden quarter-century, roughly from the rebound in economic prosperity a few years after the end of the Second World War until the early 1970s. As we all know, a series of events, including the oil shocks, ushered in the era of "stagflation", that is, a combination of economic stagnation (falling output, rising unemployment) and rising prices. This should have been impossible under a naive Keynesian view of the world. What followed is too complex and multifarious to summarize easily here, but suffice it to say that the economic difficulties of the 1970s led to the second pendulum shift, a move back towards the market and away from the state. This was the era of deregulation in the 1980s, the era of Ronald Reagan in the United States, Margaret Thatcher in the United Kingdom, and, in Canada, Brian Mulroney (remember the Shamrock Summit with President Reagan and "Irish eyes are smiling"?).

Those of us who grew up in those days will remember the deregulation of telephones, the airlines, and other industries, most importantly the banks, that had faced stiff regulation since the New Deal era. The mantra of the time, deregulation, was inspired both by Hayek, and the Chicago and Virginia Schools, that followed in his wake. The basic tenet of these libertarian economists was, to put it simply, that markets tend to work well, and governments don't. End of story. You will have gathered from my earlier remarks that this was most certainly too simplistic, and ideologically driven, a view.

4. Triumphalism in the West and the "Clash of Civilizations"

What, of course, evidently sealed the triumph, indeed the hegemony, of Anglo-American-style capitalism was the demise of the Soviet Union and the first tentative, then more fervent, embrace of liberalization and deregulation, both in its domestic manifestations, and, crucially, in its international dimension, opening up to international trade and investment, that swept the transition countries (that is, those formerly socialist economies of Eastern Europe and the former Soviet Union) and the developing countries, most notably, China, starting in the late 1970s, and India, in the early 1990s. This enthusiasm for economic liberalization, and, its international dimension, globalization, survived even the Asian financial crisis of ten years ago, and, miraculously, emerged largely unscathed after the tragedy of 9/11 and the "war on terrorism" that followed.

This was very much the era of Western, particularly Anglo-American, triumphalism, in the spirit of Francis Fukuyama's "end of history" thesis, and of Samuel Huntington's "clash of civilizations" doctrine, both of which posited the dominance and superiority of Western rationality and Judeo-Christian culture over its putative or imagined rivals in the non-Western world, and, indeed, the separateness of those cultures.

As an aside, it bespeaks an incredible impoverishment and narrowness of vision to view cultures, indeed civilizations, as disparate, discrete, and separate, and hence their hybridization as something novel and noteworthy. Such visions, politically motivated to be sure, give rise to such dangerous concepts as the "clash of civilizations", propounded, as I have noted, by Samuel Huntington, Cold Warrior *par excellence*, whose aggressively Judeo-Christian, Eurocentric, and Orientalist conception, following in the footsteps of noted Orientalists such as Bernard Lewis, fatally flawed though it is, has been embraced by policymakers and analysts in the West following the end of the Cold War and the evident emergence of unchallenged American hegemony. (History has not been as kind to Francis Fukuyama's "end of history" thesis, which has found itself upon the ash heap of history, and is not much talked about these days.) Nature abhors a vacuum, Nietzsche said, and this holds true for ruling political paradigms as well, evidently.

We would do well to recall Edward Said's spirited, indeed passionate, critique of Huntington, expressed in print and in numerous public lectures, for his forceful rebuttal of this Manichean vision of worlds at war, and of national cultures as hermetically sealed compartments, like "furniture at the back of your house", as he once put it wryly, fixed and unmoving, and possessing a concomitant ontological status, as that of an essentialized, denatured reality, deriving from this putative, albeit false, fixity. Said reminds us instead of what he beautifully terms the "radical hybridity" of culture, not only *across* national cultures, but also *within* them: in the never-ending contests and compromises between established and orthodox culture, that of priests, politicians, and other members of the power elite, and various unorthodox, or heterodox, cultures, exemplified by artists, writers, bohemians, and free-spirited and free-wheeling intellectuals, who are always, in various ways, subtly or overtly, challenging the established orthodoxies.

Alas, policymakers in Washington and London were marching in step with Huntington and his breed, heedless to the impassioned and humanistic

critique of this martial view by the likes of Said. Acolytes of globalization, and liberalization, were, consciously or not, slipping into a smug and complacent triumphalism when it came to the future of the global economy, and the doctrine of a liberal economic policy regime that has sometimes (and generally pejoratively) been called the "Washington consensus". This, too, is redolent of the earlier globalization. Then, people like Norman Angell were saying things like war is now impossible, as the economies and peoples of the world are too closely intertwined for us to contemplate destroying our collective prosperity by tearing those bonds asunder. Tragically, of course, that proved to be far too optimistic an epistle.

Even in the year or months before the financial crisis, emanating from the sub-prime mortgage fiasco in the United States, plenty of pundits were pontificating that globalization was irreversible, recessions were a thing of the past, and the only question was one of fine tuning and managing globalization and the markets, rather than fundamental questions about whether we have the right mix between the market and the government. It was thought those debates were done; over with. That thinking was wrong.

In the wake of the financial crisis, and the current global recession, teetering on the precipice of becoming a fully fledged depression, the blithe acceptance that Anglo-American economics and the system of globalization that has been supported by it will continue as before has disappeared, and been replaced, as it should, by the sobering reality that some of the difficulties we are in now were surely caused by a misguided and doctrinaire understanding of the correct role of the government in regulating the market. A fundamental rethink, in intellectual and policy making circles, is now taking place, and the pendulum is starting to swing back the other way, the third time in the past century.

As Eliot Spitzer very pithily and pungently puts it, and I paraphrase him, what we had during the last twenty years in the United States and elsewhere was libertarianism masquerading as capitalism, and, if we're not careful, what

we're likely to get in the next twenty is rank populism instead, that, if not nipped in the bud, will threaten the system of capitalism itself. This is a more provocative way of saying what I've put more prosaically, that we might be about to witness another pendulum swing, of the balance tipping from the market back to the state. Or, to be more precise, this would involve an incipient move from an insufficiently regulated market to an over-regulated one. On this fundamental point, I believe that Spitzer's framing of it is accurate, and, alas, his prediction may prove to be prescient.

5. The Crisis in Globalization

The contours of the current crisis and the reasons for this loss of faith in the market are well discussed elsewhere, so I will not rehearse these arguments here. But what I want to continue with is the the thought that, as the balance between the state and the market is being titled back towards the state, globalization too, the international manifestation of capitalism and the market system, is facing serious strains, and may, if we're not careful, start to unravel in front of our very eyes. As many analysts have been arguing, there is a "crisis in globalization". The millenarian faith in an unfettered future of ever greater and grander global economic integration, before the financial crisis, has given way to a loss of faith, like a true believer turning apostate, or, if you find that analogy too stark, the diehard anti-smoker bumming a cigarette on the sly.

Maybe I can put it another way. A spectre is haunting the world. No, it's not a socialist revolution, but something that may have as cataclysmic an effect on the global political economy. It is this self-same crisis of globalization. What concerns me here is the implications for the project of globalization. The greatest danger is that blame will be attached to globalization *per se* for the mess that we're in, whereas the primary faults lay in the failure of domestic regulatory regimes (especially as they pertain to banking and finance). So, while it might be fair to say that globalization has been poorly

managed by national economies, it would be erroneous, in my opinion, to lay the blame at the doorstep of globalization itself.

The reasoned response to being stuck in our current morass is most certainly not going to lie in turning inward, whether through raising trade barriers, closing the doors to immigration, or creating regulatory systems for international finance so onerous that capital stops flowing across borders and nurtures purely its domestic garden. Yet there are early warning signs that such an unreasoned backlash may be exactly what is on the horizon. The current outbreak of protectionist and xenophobic rhetoric in the United States may be a function, partly, of the upcoming midterm Congressional elections, but probably also reflects a deeper malaise, an anxiety about America's place in the world and the fear that its days as global hegemon may be numbered, with China, India, Brazil, and other emerging powers rising as the West stagnates.

This unease is fed, too, by rising income inequality in America, which many blame, rightly or wrongly, on globalization. Economists are divided on whether it's increased integration through trade or the nature of technological change that's the main culprit in explaining the widening gap between the wages of skilled and unskilled workers in the US. Ten years ago, many of us argued that it was mostly technology, and trade had very little to do with it. More recently, we've revised our thinking, and most economists, except a few partisans, would agree that trade has contributed, in one fashion or another, to at least some share of the changing income distribution in the US.

Is a retreat from globalization, turning into Fortress America or Fortress Europe for that matter, the right response? I don't think so.

One of the main lessons that I learned from my great teacher at Columbia University, Jagdish Bhagwati, is what has come to be known to economists as the "targeting principle", a key idea in formulating sound economic

policies. Basically it says, find the market where the underlying problem exists, and fix that. Fixing something else, that was indirectly affected, but is not the root of the problem, may or may not solve the problem, and, quite possibly, will make things worse overall. Sounds sensible, doesn't it? Medical diagnosis and treatment work in the same way, and would be the recommendation of what Jeffrey Sachs, another Columbia University economist, calls "clinical economics". How does it apply to the current situation?

In our current mess, the root of the problem is a failure in domestic regulation. Banks were allowed to behave recklessly because they were insufficiently supervised and regulated. Some of that lending, of course, took place in foreign markets, and so there is an important global dimension to the fallout from the meltdown of the misbehaving banks and their toxic debts. British banks were in danger of collapsing and became nationalized, for example, not because of something inherently wrong in the British market, but because they imprudently bought too many derivatives, known as asset-backed commercial paper, based on risky and unsound sub-prime mortgages in the United States, and engaged in other esoteric practices such as credit default swaps that no one really understood.

Is this the fault of globalization? No.

The fault lies in the failure of prudential and sensible bank regulation in each national economy, Great Britain's in this case. Globalization, by allowing this toxic debt to be spread around the world, has exacerbated the problem (although, arguably, made it less bad in the United States, where the problem originated), but is not its proximate cause.

The wisdom of the targeting principle teaches us that where national governments should be looking to fix the problem, and prevent it from happening again, is in re-regulating the banks and domestic financial systems in their national economies. (Likewise, it's domestic tax and transfer

policies that should rectify a worsening income distribution, not trade protection.) That process, of course, is starting to happen. But what is also happening, erroneously and egregiously, is that some people, populist politicians but some analysts too, are pointing a finger of blame at globalization itself, suggesting that looking inward may be part of the necessary corrective to the excesses of the past decade. This is clearly wrongheaded.

Now, openly protectionist language is rarely used, but there is always the Orwellian newspeak, which says, for example, that what we need now is not "free trade" but "free and fair trade". Why the qualification? If "free" trade is not "fair", then perhaps the thinking underlying that proposition should be explained, rather than by confusing issues and lumping "free" and "fair" together. ("Free" anything is, in itself, of course, a potentially misleading concept, as I suggested earlier, in the context of the term "free market". "Free trade" is, I think, less suspect, since most people understand correctly from it that it refers to trade unfettered by tariffs and other protective barriers, not that it implies trade in a world with no government intervention of any sort.)

One could take things back a step, and make a more sophisticated, second-order, argument, suggesting that globalization in some way induced risky behaviour by banks, or created pressure on domestic regulators to relax regulations excessively, because they wanted their national champions to succeed in a more competitive global environment or to attract a greater share of the pool of global capital sloshing around. This is a species of what is often called the "race to the bottom" argument. This is a more difficult one to deal with, since no government is going to admit that it allowed regulations to become laxer because they wanted to compete more aggressively in global markets. So the causal connection, while it may exist in theory, is difficult to confirm or confute in practice.

There might be some truth to this argument, perhaps, when it comes to very small, highly open economies that hooked themselves on foreign capital. The problems in Iceland, or Ireland, or in several Eastern European emerging market economies might reflect a deliberate degradation of domestic banking norms and regulations in the hope of enticing foreign investors to their shores. But the correct response, surely, is not to pour good champagne down the drain because you can't recork it, and start de-globalizing as a response, but to repair the poor domestic regulatory framework that induced the problem in the first place.

What confuses and confounds in this situation is that globalization is taken to be a monolithic construct, so that it is assumed to mean liberalization of everything, whereas it is perfectly logically consistent to favour free (or freer) trade in goods, services, and even foreign direct investment across borders, but be wary of unfettered flows of short term capital, or "hot" money, that have the potential to destabilize small economies heavily reliant on them, as we have witnessed both in the Asian financial crisis of the previous decade and our recent global financial crisis. This is a point on which both the "defenders" of globalization, such as Jagdish Bhagwati, and those who point to its "discontents", such as Joseph Stiglitz, can agree.

This argument, in any case, carries little weight, when applied to the United States and the United Kingdom, the chief culprits in the current global crisis. It was not globalization, but rather the de-regulatory zeal of Ronald Reagan in the United States and Margaret Thatcher in the United Kingdom that swept away a host of regulations, many bad, but, some, as we know now, not only good, but essential, for the sound functioning of a modern global economy.

The apparent (and in many ways, very real) success of deregulation in these two countries, along with the collapse of the Soviet system and the disappearance of a viable socialist alternative, is what acted as the driver for

liberalizing and globalizing reforms in the transition and emerging countries, the "BRICs" (Brazil, Russia, India, and China) in particular.

Now, these four economies are amongst the most globalized of all of the major developing and emerging market economies, and they potentially stand the greatest to lose, if globalization goes into reverse gear, or, worse still, if it stalls. Thinking through the attitudes and potential policy responses in these major emerging economies is an important challenge, both for policymakers there and for those living in the West. Our economic future, and those of our children and their children, rest on how well we do this.

6. The Rise of the BRICs and the Future of Globalization

The importance of these large emerging economies can be demonstrated with a simple example. When I begin my development economics course, I ask students to tell me which they think were the largest and richest countries in the world at the beginning of the 18th century. Most guess Britain or France. Few know that it was China and India. Today, three centuries later, they are poised once again to contend for the top spot. The intervening three centuries of Western global domination, aided and abetted by colonization, imperialism, and military power, may, after all, appear as the merest fraction of time, for two civilizations that date their histories in millennia, not centuries. Make no mistake: China and India are on the march, brimming with self-confidence, and looking to regain their primacy in world affairs.

Sounds far-fetched? Computed at purchasing power parity, China is already the world's second-largest economy, and India is fourth or fifth. Of course, these are aggregate, not per capita, statistics: since each country houses over a billion people each, and together they amount to a third of the world's population, incomes per person are low, but rising, and poverty levels, while falling, are still high. Nonetheless, if you add Brazil and Russia, the two other members of the club dubbed the BRICs by Jim O'Neill of

Goldman Sachs, and a few other large emerging economies for good measure, such as South Africa, you have a large share of the world's population and a growing share of the world's economic activity.

Some in the West assume that the rise of the BRICs must mean the decline of the West. In terms of absolute incomes, of course, this is not true: increased international integration through trade and finance, if well managed, should be mutually gainful, so that it is, strictly speaking, incorrect to say that one bloc is gaining at the expense of the other. In relative terms, however, a rising share of global income accruing to the emerging economies *necessarily* implies an equivalently falling share for the currently rich economies. Growing the pie isn't a zero-sum game, but splitting an existing pie is.

Economists are dismissive of such comparisons, since within the narrow logic of the rational choice paradigm that they typically deploy, with its assumption of individual instrumental rationality, all that matters is an individual's absolute income, and, by extension, a nation's per capita income, which captures the income of its average citizen. By this metric, it is true that incomes in the West will remain higher for a long time to come, and average incomes in the emerging countries will remain low.

What this argument entirely misses is something that political scientists and social psychologists have long realized, and economists have blithely ignored: for individuals, what matters in many situations is relative, not absolute, comparisons, including of income -- in particular, the direction of change; and, for nations, absolute (as opposed to per capita) size does matter in determining power relationships. Through this lens, the rise of the BRICs indeed represents a potentially seismic shift in the global political economy, a phenomenon that the West will need to understand and adapt to, if the future of globalization in this century is to be a positive one.

It has become commonplace to argue that what we are witnessing today represents an incipient, or at any rate putative, shift in economic and political power from the North Atlantic region to the Asia Pacific region. While such an assertion may be premature, it's entirely consistent with the trends that we've been seeing for the past decade or two, and certainly in the past few years since the onset of the global financial crisis. After all, rapid growth in China and India has mitigated, to some extent, the impact on the global economy of the recession in the US and Europe. The question that arises is this: How will the institutions that govern the global political economy, which date to the end of the Second World War and crystallize the hegemony of the Anglo-American world and its worldview, need to adapt in the face of these recent changes?

Common sense would suggest that those institutions do need to be refreshed, although, not surprisingly, the argument as to why that shouldn't happen has already begun from those fighting a rearguard action to protect the status quo -- most recently, for instance, by Jorge Castañeda writing in *Foreign Affairs*. This probably reflects wishful thinking, since change has already begun to take hold. Even now, the G8 has been all but supplanted by the G20 as the principal forum for global economic policy discourse and coordination of international trade, finance, and currency arrangements. The latter group not only subsumes the former, the richest economies in the world, all Western (excepting Japan), but adds the BRICs and other large emerging economies.

The rise of the BRICs also brings to the fore the observation that Western-style liberal democracy is not the only road to economic success. There is an old debate in political science, on whether democracy is good or bad for economic development; another on whether development in turn leads to democratization through the growth of a middle class (the Lipset thesis). These debates have been rendered moot by the simultaneous success of countries with such diverse histories, cultures, and political systems: spanning the spectrum from thoroughly democratic India and Brazil, to

increasingly autocratic Russia, to authoritarian China. Whether anyone in the West likes it or not, all of these countries have earned a place at the global table, and they're going to claim it, one way or another, in the not too distant future.

Equally noteworthy is the increasing coordination amongst the emerging economies on matters of common concern. In the perennially stalled Doha Development Round of the WTO, for instance, China, India, Brazil, and other large emerging countries have forged a negotiating bloc, and are not caving in to the US or the EU on the current sticking points such as agricultural subsidies. They remember the experience of the Uruguay Round of the GATT, in which a still supine developing world was forced to swallow provisions on intellectual property protection which went against their interests and served rich country multinationals.

In similar fashion, China and India have taken the lead in articulating the developing countries' perspective in international climate negotiations, and resisting pressure from the rich countries to accept binding cuts of greenhouse gas emissions without suitable compensation. The spectacular failure of the Copenhagen summit in 2009 points up the fact that the world is still groping towards a new global architecture that deals in a meaningful fashion with climate change, while at the same time incorporating the legitimate aspirations for continued economic growth and development in the poorer countries, a process which everyone knows is going to be carbon-intensive. Negotiating, both intellectually and practically, this potentially existential trade-off between climate change and economic development will surely shape the contours of the globalization debate in the coming years.

Debates about the "free market" and the future of globalization are sterile, unless they lead to concrete action by governments and international organizations: else, they amount to little more than academic onanism, to borrow a felicitous turn of phrase from Leonard Bernstein. Nor is it helpful if

partisans stake out extreme positions and resort to rhetorical postures rather than nuanced and shaded understandings of the complex relationship between market and state, between national and global economies. There are economists who speak in defence of globalization, while others decry its discontents.

By contrast, a few years ago, before the recent crisis, James Dean and I wrote an essay in which we tried to make the case for what we called "optimal globalization", to ensure that the fruits of liberalization would be spread as widely as possible, and its harms ameliorated. We highlighted broad policy measures that developing and emerging market governments ought to pursue, in particular, "appropriate governance, transparency, optimal regulation of labour, product and financial markets, institutional safeguards, and adjustment assistance". This is still the right advice today. It is not easy an easy path to follow, but, for all of our sakes, we had better stick to it.

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A NOTE ON THE TEXT

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