What is to be Done? The End of the Washington Consensus

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Wall Street's financial meltdown marks the end of an era. What has ended is the credibility of the Washington Consensus – open markets to foreign investors and tight money austerity programs (high interest rates and credit cutbacks) to "cure" balance-of-payments deficits, domestic budget deficits and price inflation. On the negative side, this model has failed to produce the prosperity it promises. Raising interest rates and dismantling protective tariffs and subsidies worsen rather than help the trade and payments balance, aggravate rather than reduce domestic budget deficits, and raise prices. The reason? Interest is a cost of doing business while foreign trade dependency and currency depreciation raise import prices.

But even more striking is the positive side of what can be done as an alternative to the Washington Consensus. The $700 billion U.S. Treasury bailout of Wall Street's bad loans on October 3 shows that the United States has no intention of applying this model to its own economy. Austerity and "fiscal responsibility" are for other countries. America acts ruthlessly in its own economic interest at any given moment of time. It freely spends more than it earns, flooding the global economy with what has now risen to $4 trillion in U.S. government debt to foreign central banks.

This amount is unpayable, given the chronic U.S. trade deficit and overseas military spending. But it does pose an interesting problem: why can't other countries do the same thing? Is today's policy asymmetry a fact of nature, or is it merely voluntary and the result of ignorance (spurred by an intensive globalist ideological propaganda program, to be sure)? Does India, for instance, need to privatize its state-owned banks as earlier was planned, or is it right to pull back? More to the point, have the neoliberal programs imposed on the former Soviet Union succeeded in "Americanizing" their economies and raising production capacity and living standards as promised? Or, was it all a dream, indeed, a nightmare?

The three Baltic countries, for instance – Latvia, Estonia and Lithuania – have long been praised in the Western press as great success stories. The World Bank classifies them among the most "business friendly" countries, and their real estate prices have soared, fueled by foreign-currency mortgages from neighboring Scandinavian banks. Their industry has been dismantled, their agriculture is in ruins, their male population below the age of 35 is emigrating. But real estate prices added to the net worth on their national balance sheets for nearly a decade. Has a new "moment of truth" arrived? Just because the Soviet economic system culminated in bureaucratic kleptocracy, has the neoliberal model really been so much better? Most important of all, was there a better alternative all along?

We expect the post-Soviet economies to go the way of Iceland, having taken on foreign debt with no visible means of paying it off via exports (the same situation in which the United States finds itself), or even further asset sales. Emigrants' remittances are becoming a mainstay of their balance of payments, reflecting their economic shrinkage at the hands of neoliberal "reformers" and the free-market international dependency that the Washington Consensus promotes. So, just as this crisis has led the U.S. government to shift gears, is it time for foreign countries to seek to become more in the character of "mixed economies"? This has been the route taken by every successful economy in history, after all. Total private-sector markets (in practice, markets run by the banks and money managers) have shown themselves to be just as destructive, wasteful and corrupt and, indeed, centrally planned as those of totally "statist" governments from Stalin's Russia to Hitler's Germany. Is the political pendulum about to swing back more toward a better public-private balance?

Washington's idealized picture of how free markets operate (as if such a thing ever existed) promised that countries outside the United States would get rich faster, approaching U.S.-style living standards if they let global investors buy their key industries and basic infrastructure. For half a century, this neoliberal model has been a hypocritical exercise in poor policy at best, and deception at worst, to convince other economies to impose self-destructive financial and tax policies, enabling U.S. investors to swoop in and buy their key assets at distress prices. (And for the U.S. economy to pay for these investment outflows in the form of more and more U.S. Treasury IOUs, yielding a low or even negative return when denominated in hard currencies.)

The neoliberal global system never was open in practice. America never imposed on itself the kind of shock therapy that President Clinton's Treasury Secretary (and now Obama's advisor) Robert Rubin promoted in Russia and the rest of the former Soviet bloc, from the Baltic countries in the northwest to Central Asia in the southeast. Just the opposite! Despite the fact that America's own balance of trade and payments is soaring, consumer prices are rising and financial and property markets are plunging, there are no calls among its power elite to let the system self-correct. The Treasury is subsidizing America's financial markets so as to save its financial class (minus some sacrificial lambs) and support its asset prices. Interest rates are being lowered to re-inflate asset prices, not raised to stabilize the dollar or slow domestic price inflation.

The policy implications go far beyond the United States itself. If the United States can create so much credit so quickly and so freely – and if Europe can follow suit, as it has done in recent days – why can't all countries do this? Why can't they get rich by following that path that the United States actually has taken, rather than merely doing what its economic diplomats tell them to do with sweet self-serving rhetoric? U.S. experience itself provides the major reason why the free market, run by financial institutions allocating credit, is a myth, a false map of reality to substitute for actual gunboats in getting other countries to open their asset markets to U.S. investors and food markets to U.S. farmers.

By contrast, the financial and trade model that U.S. oligarchs and their allies are promoting is a double standard. Most notoriously, when the 1997 Asian financial crisis broke out, the IMF demanded that foreign governments sell out their banks and industry at fire-sale prices to foreigners. U.S. vulture capital firms were especially aggressive in grabbing Asian and other global assets. But the U.S. financial bailout stands in sharp contrast to what Washington Consensus institutions imposed on other countries. There is no intention of letting foreign investors buy into the commanding U.S. heights, except at exorbitant prices. And for industry, the United States has once more violated international trade rules by offering special bailout money and subsidies to its own Big Three U.S. automakers (General

Motors, Ford and Chrysler) but not to foreign-owned automakers in the United States. In thus favoring its own national industry and taking punitive measures to injure foreign-owned investments, the United States is once again providing an object lesson in nationalistic economic policy.

Most important, the U.S. bailout provides a model that is far preferable to the Washington Consensus-for-export. It shows that countries do not need to borrow credit from foreign banks at all. The government could have created its own money and credit system rather than leaving foreign creditors to accrue interest charges that now represent a permanent and seemingly irreversible balance-of-payments drain. The United States has shown that any country can monetize its own credit, at least domestic credit. A large part of the problem for Third World and post-Soviet economies is that they never experienced the successful model of managerial capitalism that predated the neoliberal model, advocated since the 1980s by Washington.

The managerial model of capitalism, predominating during the post-World War II period until the 1980s (with antecedents in 18th-century British mercantilism and 19th-century American protectionism), delivered high growth. Postwar planners, such as John Maynard Keynes in England and Harry Dexter White in the United States, favored production over finance. As Winston Churchill quipped, “nations typically do the right thing [pause], after exhausting all other options.” But it took two world wars, interspersed by an economic depression triggered by debts in excess of the ability to pay, to give the final nudge required to promote manufacturing over finance and finally do “the right thing.”

Finance was made subordinate to industrial development and full employment. When this economic philosophy reached its peak in the early 1960s, the financial sector accounted for only 2 per cent of U.S. corporate profits. Today, it is 40 per cent! Carrying charges on America’s exponentially growing debt are diverting income away from purchasing goods and services to pay creditors, who use the money mainly to lend out afresh to borrowers to bid up real estate prices and stock prices. Tangible capital investment is financed almost entirely out of retained corporate earnings – and these too are being diverted to pay interest on soaring industrial debt. The result is debt deflation – a shrinkage of spending power as the economic surplus is “financialized,” a new word, only recently added to the world’s economic vocabulary.

Since the 1980s, the U.S. tax system has promoted rent seeking and speculation on credit to ride the wave of asset-price inflation. This strategy increased balance sheets as long as asset prices rose faster than debts (that is, until last year). But it did not add to industrial capacity. And meanwhile, tax cuts caused the national debt to soar, prompting U.S. Vice President Dick Cheney to comment, “Reagan proved deficits don’t matter.”

On the international front, the larger the U.S. trade and payments deficit, the more dollars were pumped into foreign hands. Their central banks recycled them back to the U.S. economy in the form of purchases of Treasury bonds and, when the interest rates fell almost to zero, securitized mortgage packages. Current Treasury Secretary Henry Paulson assured Chinese and other foreign investors that the government would stand behind Fannie Mae and Freddie Mac as privatized mortgage-packaging agencies, guaranteeing a $5.2 trillion supply of mortgages. This matched in size the U.S. public debt in private hands.

Meanwhile, the Treasury cut special deals with the Saudis to recycle their oil revenues into investments in Citibank and other U.S. financial institutions – investments, on which they have lost many tens of billions of dollars. To cap matters, pricing world oil in dollars kept the U.S. currency stronger than underlying economic fundamentals justified. The U.S. economy paid for its imports with government debt never intended to be repaid, even if it could be (which it can't at today's $4 trillion level, cited earlier). The American economy, thus, has seen its trade deficit and asset prices rise in accordance with economic laws that no other nation can emulate, topped by the ability to run freely into international debt without limit.

Managerial capitalism mobilized rising corporate net worth and equity value to build up in the real economy. But since the 1980s, a new breed of financial managers has pledged assets as collateral for new loans to buy back corporate stock and even to pay out as dividends. This has pushed up corporate stock prices and, with them, the value of stock options that corporate managers give themselves. But it has not spurred tangible capital formation.

A real estate bubble in all countries has been fueled by rising mortgage debt. To buy a new home, buyers must take on a lifetime of debt. This has made many employees afraid to go on strike or even to press for better working conditions, because they are "one check away from homelessness," or mortgage foreclosure. Meanwhile, companies have been outsourcing and downsizing their labor force, eliminating benefits, imposing longer hours, and bringing more women and children into the workforce.

Today's "new economy" is based not on new technology and capital investment, as former Fed chairman Alan Greenspan trumpeted in the late 1990s, but on price inflation generating capital gains (mainly in land prices, as land is still the largest asset in the U.S. and other industrial economies). The economic surplus is absorbed by debt service payments (and higher priced health care), not investment in production or in sharing productivity gains with labor and professionals. Wages and living standards are stagnant for most people, as the economy tries to get rich by "the miracle of compound interest," while capital gains emanating from the financial sector provide a foundation for new credit to bid up asset prices, all the more in a seemingly perpetual motion credit-and-debt machine. But the effect has been for the richest 1 per cent of the population to increase its share of interest extraction, dividends and capital gains from 37 per cent ten years ago to 57 per cent five years ago, and nearly 70 per cent today. Savings remain high, but only the wealthiest 10 per cent are saving – and this money is being lent out to the bottom 90 per cent, so no net saving is occurring.

Internationally, too, the global economy has polarized rather than converged. Just as independence arrived for many Third World countries only after their former European colonial powers had put in place inequitable land tenure patterns (latifundia, owned by domestic oligarchies) and export-oriented production, so independence for the post-Soviet countries from Russia arrived after managerial capitalism had given way to a neoliberal model that viewed "wealth creation" simply as rising prices for real estate, stocks and bonds. Western advisors and former emigrants descended to convince these countries to play the same game that other countries were playing – except that real estate debt for many of these countries was denominated in foreign currency, as no domestic banking tradition had been developed. This became increasingly dangerous for economies that did not put in place sufficient export capacity to cover the price of imports and the mounting volume of foreign-currency debt attached to their real estate. And nearly all the post-Soviet countries ran structural trade deficit, as production patterns were disrupted with the breakup of the U.S.S.R.

Real estate and capital gains from asset-price inflation (not industrial capital formation) were promoted as the way to future prosperity in countries whose profits from manufacturing were low and wages were stagnant. The problem is this alchemy is not sustainable. An illusion of success could be maintained as long as Washington was flooding the globe with cheap money. This led Swedes and other Europeans to find capital gains by extending loans to feed neighboring countries from Iceland to Latvia, above all via their real estate markets. For some exporters (especially Russia), rising oil and metal export prices became the basis for capital outflows into Third World and post-Soviet financial markets. Some of the backwash, for example, flowed into the world's burgeoning offshore banking and real estate sectors – only to stop abruptly when the real estate bubble burst.

In these circumstances, what is to be done? First, countries outside the United States need to recognize how dysfunctional the neoliberalized world economy has been made, and to decide which assumptions underlying the neoliberal model must be discarded. Its preferred tax and financial policies favor finance over industry and, hence, financial maneuvering and asset-price inflation over tangible capital formation. Its anti-labor austerity policies and un-taxing of real estate, stocks and bonds divert resources away from growth and rising living standards.

Likewise destructive are compound interest and capital gains over the long term. The real economy can grow only a few per cent a year at best. Therefore, it is mathematically impossible for compound interest to continue unabated and for capital gains to grow well in excess of the underlying rate of economic growth. Historically, economic crises wipe out these gains when they outpace real economic growth by too far a margin. The moral is that compound interest and hopes for capital gains cannot guarantee income for its retirees or continue attracting foreign capital. Over a period of a lifetime, financial investments may not deliver significant gains. For the United States, it took markets about twenty-five years, from 1929 to the mid-1950s, to recover their previous value.

Today's desperate U.S. attempt to re-inflate post-crash prices cannot cure the bad-debt problem. Foreign attempts to do this will merely aid foreign bankers and financial investors, not the domestic economy. Countries need to invest in their real economy, to raise productivity and wages. Governments must punish speculation and capital gains that merely reflect asset-price inflation, not real value. Otherwise, the real economy's productive powers and living standards will be impaired and, in the neoliberal model, loaded down with debt. Policies should encourage enterprise, not speculation. Investment seeks growing markets, which tend to be thwarted by macroeconomic targets such as low inflation and balanced budgets. We are not arguing that inflation and deficits can be ignored, but rather that inflation and deficits are not all created equally. Some variants hurt the economy, while others reflect healthy investment in real production. Distinguishing between the two effects is vital, if economies are to move forward to achieve self-dependency.

In sum, a much better economy can be created by rejecting Washington's financial model of austerity programs, privatization selloffs and trade dependency, financed by foreign-currency credit. Prosperity cannot be achieved by creating a favorable climate for extractive foreign capital, or by tightening credit and balancing budgets, decade after decade. The United States itself has always rejected these policies, and foreign countries also must do this if they wish to follow the policies, by which America actually grew rich, not by what U.S. neoliberal advisors tell other countries to do to please U.S. banks and foreign investors.

Also to be rejected is the anti-labor neoliberal tax policy (heavy taxes on employees and employers, low or zero taxes on real estate, finance and capital gains) and anti-labor workplace policies, ranging from safety protection and health care to working conditions. The U.S. economy rose to dominance as a result of Progressive Era regulatory reforms prior to World War I, reinforced by popular New Deal reforms put in place in the Great Depression. Neoliberal economics was promoted as a means of undoing these reforms. By undoing them, the Washington Consensus would deny to foreign countries the development strategy that has best succeeded in creating thriving domestic markets, rising productivity, capital formation and living standards. The effect has been to decouple saving from tangible capital formation. They need to be re-coupled, and this can be achieved only by restoring the kind of mixed economy by which North America and Europe achieved their economic growth.

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