VANITY FAIR

ECONOMICS

Wall Street's Toxic Message

When the current crisis is over, the reputation of American-style capitalism will have taken a beating—not least because of the gap between what Washington practices and what it preaches. Disillusioned developing nations may well turn their backs on the free market, warns Nobel laureate Joseph E. Stiglitz, posing new threats to global stability and U.S. security.

By JOSEPH E. STIGLITZ July 2009

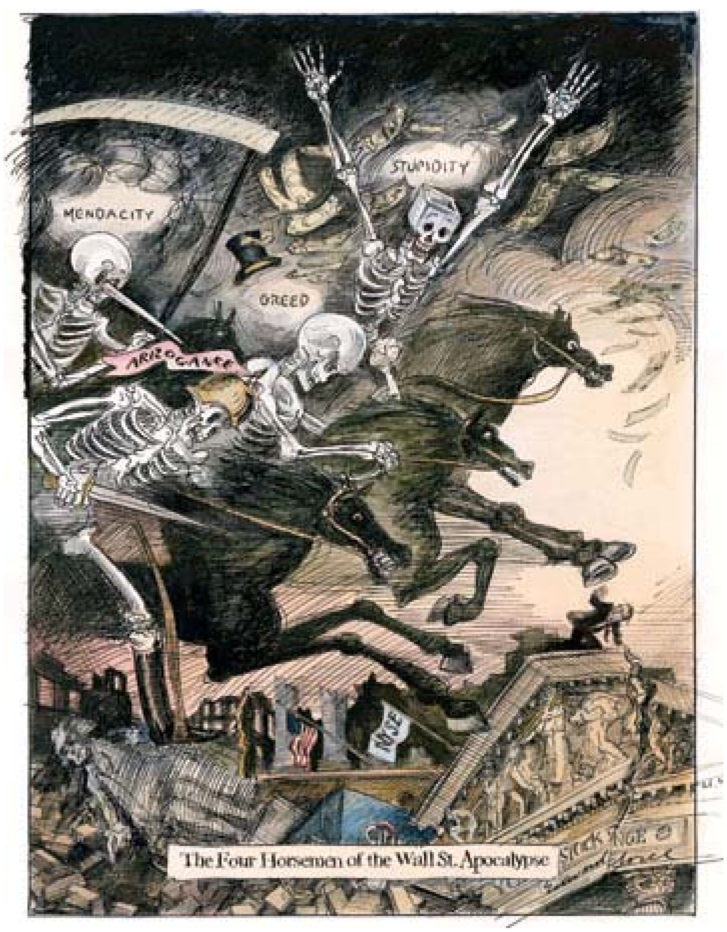


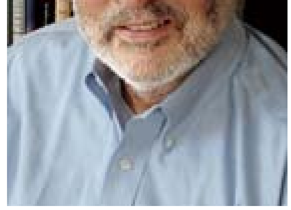
Illustration by Edward Sorel.

Every crisis comes to an end—and, bleak as things seem now, the current economic crisis too shall pass. But no crisis, especially one of this severity, recedes without leaving a legacy. And among this one's legacies will be a worldwide battle over ideas—over what kind of economic system is likely to deliver the greatest benefit to the most people. Nowhere is that battle raging more hotly than in the Third World, among the 80 percent of the world's population that lives in Asia, Latin America, and Africa, 1.4 billion of whom subsist on less than $1.25 a day. In America, calling someone a socialist may be nothing more than a cheap shot. In much of the world, however, the battle between capitalism and socialism—or at least something that many Americans would label as socialism—still rages. While there may be no winners in the current economic crisis, there are losers, and among the big losers is support for American-style capitalism. This has consequences we'll be living with for a long time to come.

The fall of the Berlin Wall, in 1989, marked the end of Communism as a viable idea. Yes, the problems with Communism had been manifest for decades. But after 1989 it was hard for anyone to say a word in its defense. For a while, it seemed that the defeat of

MORE STIGLITZ

Communism meant the sure victory of capitalism, particularly in its American form. Francis Fukuyama went as far as to proclaim "the end of history," defining democratic market capitalism as the final stage of social development, and declaring that all humanity was now heading in this direction. In truth, historians will mark the 20 years since 1989 as the short period of American triumphalism. With the collapse of great banks and financial houses, and the ensuing economic turmoil and chaotic attempts at rescue, that period is over. So, too, is the debate over "market fundamentalism," the notion that unfettered markets, all by themselves, can ensure economic prosperity and growth. Today only the deluded would argue that markets are self-correcting or that we can rely on the self-interested behavior of market participants to guarantee that everything works honestly and properly.


Joseph E. Stiglitz on the economic crisis.

Capitalist Fools, January 2009

Reversal of Fortune, November 2008

The $3 Trillion War, April 2008 (with Linda J. Bilmes)

The Economic Consequences of Mr. Bush, December 2007

The economic debate takes on particular potency in the developing world. Although we in the West tend to forget, 190 years ago one-third of the world's gross domestic product was in China. But then, rather suddenly, colonial exploitation and unfair trade agreements, combined with a technological revolution in Europe and America, left the developing countries far behind, to the point where, by 1950, China's economy constituted less than 5 percent of the world's G.D.P. In the mid–19th century the United Kingdom and France actually waged a war to open China to global trade. This was the Second Opium War, so named because the West had little of value to sell to China other than drugs, which it had been dumping into Chinese markets, with the collateral effect of causing widespread addiction. It was an early attempt by the West to correct a balance-of-payments problem.

Colonialism left a mixed legacy in the developing world—but one clear result was the view among people there that they had been cruelly exploited. Among many emerging leaders, Marxist theory provided an interpretation of their experience; it suggested that exploitation was in fact the underpinning of the capitalist system. The political independence that came to scores of colonies after World War II did not put an end to economic colonialism. In some regions, such as Africa, the exploitation—the extraction of natural resources and the rape of the environment, all in return for a pittance—was obvious. Elsewhere it was more subtle. In many parts of the world, global institutions such as the International Monetary Fund and the World Bank came to be seen as instruments of post-colonial control. These institutions pushed market fundamentalism ("neoliberalism," it was often called), a notion idealized by Americans as "free and unfettered markets." They pressed for financial-sector deregulation, privatization, and trade liberalization.

The World Bank and the I.M.F. said they were doing all this for the benefit of the developing world. They were backed up by teams of free-market economists, many from that cathedral of free-market economics, the University of Chicago. In the end, the programs of "the Chicago boys" didn't bring the promised results. Incomes stagnated. Where there was growth, the wealth went to those at the top. Economic crises in individual countries became ever more frequent—there have been more than a hundred severe ones in the past 30 years alone.

Not surprisingly, people in developing countries became less and less convinced that Western help was motivated by altruism. They suspected that the free-market rhetoric—"the Washington consensus," as it is known in shorthand—was just a cover for the old commercial interests. Suspicions were reinforced by the West's own hypocrisy. Europe and America didn't open up their own markets to the agricultural produce of the Third World, which was often all these poor countries had to offer. They forced developing countries to eliminate subsidies aimed at creating new industries, even as they provided massive subsidies to their own farmers.

Free-market ideology turned out to be an excuse for new forms of exploitation. "Privatization" meant that foreigners could buy mines and oil fields in developing countries at low prices. It meant they could reap large profits from monopolies and quasi-monopolies, such as in telecommunications. "Liberalization" meant that they could get high returns on their loans—and when loans went bad, the I.M.F. forced the socialization of the losses, meaning that the screws were put on entire populations to pay the banks back. It meant, too, that foreign firms could wipe out nascent industries, suppressing the development of entrepreneurial talent. While capital flowed freely, labor did not—except in the case of the most talented individuals, who found good jobs in a global marketplace.

This picture is, obviously, painted with too broad a brush. There were always those in Asia who resisted the Washington consensus. They put restrictions on capital flows. The giants of Asia—China and India—managed their economies their own way, producing unprecedented growth. But elsewhere, and especially in the countries where the World Bank and the I.M.F. held sway, things did not go well.

And everywhere, the debate over ideas continued. Even in countries that have done very well, there is a conviction among the educated and influential that the rules of the game have not been fair. They believe that they have done well *despite* the unfair rules, and they sympathize with their weaker friends in the developing world who have not done well at all.

Among critics of American-style capitalism in the Third World, the way that America has responded to the current economic crisis has been the last straw. During the East Asia crisis, just a decade ago, America and the I.M.F. demanded that the affected countries cut their deficits by cutting back expenditures—even if, as in Thailand, this contributed to a resurgence of the AIDS epidemic, or even if, as in Indonesia, this meant curtailing food subsidies for the starving. America and the I.M.F. forced countries to raise interest rates, in some cases to more than 50 percent. They lectured Indonesia about being tough on its banks—and demanded that the government not bail them out. What a terrible precedent this would set, they said, and what a terrible intervention in the Swiss-clock mechanisms of the free market.

The contrast between the handling of the East Asia crisis and the American crisis is stark and has not gone unnoticed. To pull America out of the hole, we are now witnessing massive increases in spending and massive deficits, even as interest rates have been brought down to zero. Banks are being bailed out right and left. Some of the same officials in Washington who dealt with the East Asia crisis are now managing the response to the American crisis. Why, people in the Third World ask, is the United States administering different medicine to itself?

Many in the developing world still smart from the hectoring they received for so many years: they should adopt American institutions, follow our policies, engage in deregulation, open up their markets to American banks so they could learn "good" banking practices, and (not coincidentally) sell their firms and banks to Americans, especially at fire-sale prices during crises. Yes, Washington said, it will be painful, but in the end you will be better for it. America sent its Treasury secretaries (from both parties) around the planet to spread the word. In the eyes of many throughout the developing world, the revolving door, which allows American financial leaders to move seamlessly from Wall Street to Washington and back to Wall Street, gave them even more credibility; these men seemed to combine the power of money and the power of politics. American financial leaders were correct in believing that what was good for America or the world was good for financial markets, but they were incorrect in thinking the converse, that what was good for Wall Street was good for America and the world.

It is not so much Schadenfreude that motivates the intense scrutiny by developing countries of America's economic failure as it is a real need to discover what kind of economic system can work for them in the future. Indeed, these countries have every interest in seeing a quick American recovery. What they know is that they themselves cannot afford to do what America has done to attempt to revive its economy. They know that even this amount of spending isn't working very fast. They know that the fallout from America's downturn has moved 200 million additional people into poverty in the span of just a few years. And they are increasingly convinced that any economic ideals America may espouse are ideals to run from rather than embrace.

Why should we care that the world has become disillusioned with the American model of capitalism? The ideology that we promoted has been tarnished, but perhaps it is a good thing that it may be tarnished beyond repair. Can't we survive—even do just as well—if not everyone adheres to the American way?

To be sure, our influence will diminish, as we are less likely to be held up as a role model, but that was happening in any case. America used to play a pivotal role in global capital, because others believed that we had a special talent for managing risk and allocating financial resources. No one thinks that now, and Asia—where much of the world's saving occurs today—is already developing its own financial centers. We are no longer the chief source of capital. The world's top three banks are now Chinese. America's largest bank is down at the No. 5 spot.

The dollar has long been the reserve currency—countries held the dollar in order to back up confidence in their own currencies and governments. But it has gradually dawned on central banks around the world that the dollar may not be a good store of value. Its value has been volatile, and declining. The massive increase in America's indebtedness during the current crisis, combined with the Federal Reserve Board's massive lending, has heightened anxieties about the future of the dollar. The Chinese have openly floated the idea of inventing some new reserve currency to replace it.

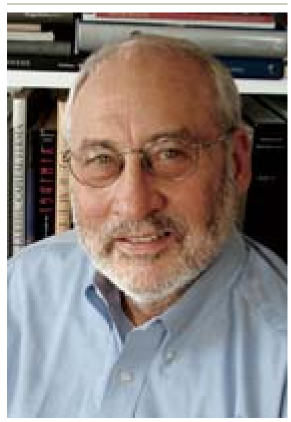
Meanwhile, the cost of dealing with the crisis is crowding out other needs. We have never been generous in our assistance to poor countries. But matters are getting worse. In recent years, China's infrastructure investment in Africa has been greater than that of the World Bank and the African Development Bank combined, and it dwarfs America's. African countries are running to Beijing for assistance in this crisis, not to Washington.

But my concern here is more with the realm of ideas. I worry that, as they see more clearly the flaws in America's economic and social system, many in the developing world will draw the wrong conclusions. A few countries—and maybe America itself—will learn the right lessons. They will realize that what is required for success is a regime where the roles of market and government are in balance, and where a strong state administers effective regulations. They will realize that the power of special interests must be curbed.

But, for many other countries, the consequences will be messier, and profoundly tragic. The former Communist countries generally turned, after the dismal failure of their postwar system, to market capitalism, replacing Karl Marx with Milton Friedman as their god. The new religion has not served them well. Many countries may conclude not simply that unfettered capitalism, American-style, has failed but that the very concept of a market economy has failed, and is indeed unworkable under any circumstances. Old-style Communism won't be back, but a variety of forms of excessive market intervention will return. And these will fail. The poor suffered under market fundamentalism—we had trickle-up economics, not trickle-down economics. But the poor will suffer again under these new regimes, which will not deliver growth. Without growth there cannot be sustainable poverty reduction. There has been no successful economy that has not relied heavily on markets. Poverty feeds disaffection. The inevitable downturns, hard to manage in any case, but especially so by governments brought to power on the basis of rage against American-style capitalism, will lead to more poverty. The con?sequences for global stability and American security are obvious.

There used to be a sense of shared values between America and the American-educated elites around the world. The economic crisis has now undermined the credibility of those elites. We have given critics who opposed America's licentious form of capitalism ample ammunition to preach a broader anti-market philosophy. And we keep giving them more and more ammunition. While we committed ourselves at a recent G-20 meeting not to engage in protectionism, we put a "buy American" provision into our own stimulus package. And then, to soften the opposition from our European allies, we modified that provision, in effect discriminating against only poor countries. Globalization has made us more interdependent; what happens in one part of the world affects those in another—a fact made manifest by the contagion of our economic difficulties. To solve global problems, there must be a sense of cooperation and trust, including a

MORE STIGLITZ



Joseph E. Stiglitz on the economic crisis.

Capitalist Fools, January 2009

Reversal of Fortune, November 2008

The $3 Trillion War, April 2008 (with Linda J. Bilmes) sense of shared values. That trust was never strong, and it is weakening by the hour.

The Economic Consequences of Mr. Bush, December 2007

Faith in democracy is another victim. In the developing world, people look at Washington and see a system of government that allowed Wall Street to write self-serving rules which put at risk the entire global economy—and then, when the day of reckoning came, turned to Wall Street to manage the recovery. They see continued re-distributions of wealth to the top of the pyramid, transparently at the expense of ordinary citizens. They see, in short, a fundamental problem of political accountability in the American system of democracy. After they have seen all this, it is but a short step to conclude that something is fatally wrong, and inevitably so, with democracy itself.

The American economy will eventually recover, and so, too, up to a point, will our standing abroad. America was for a long time the most admired country in the world, and we are still the richest. Like it or not, our actions are subject to minute examination. Our successes are emulated. But our failures are looked upon with scorn. Which brings me back to Francis Fukuyama. He was wrong to think that the forces of liberal democracy and the market economy would inevitably triumph, and that there could be no turning back. But he was not wrong to believe that democracy and market forces are essential to a just and prosperous world. The economic crisis, created largely by America's behavior, has done more damage to these fundamental values than any totalitarian regime ever could have. Perhaps it is true that the world is heading toward the end of history, but it is now sailing against the wind, on a course we set ourselves.

Joseph E. Stiglitz, a Nobel Prize–winning economist, is a professor at Columbia University.