

THE END OF  
LAISSEZ-FAIRE



NATIONAL PURPOSE  
AND THE GLOBAL ECONOMY  
AFTER THE COLD WAR

ROBERT KUTTNER

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## INTRODUCTION

The *end* of laissez-faire? Surely the collapse of communism, the globalization of commerce, and the triumph of capitalist ideas all signal a new golden age of laissez-faire. The remarkable events of 1989-90 have been widely heralded as a victory for the free market—a vindication of laissez-faire in general and American-style capitalism in particular. Indeed, it has become a cliché to declare that the United States is now the only nation that remains both an economic and a military superpower. But that conclusion, I suspect, is far too facile as a guide either to ideology or to policy.

\* In the new era now unfolding, the pursuit of laissez-faire as an optimum goal, for the global system or for the United States, would do grave harm to both.

\* In this book, I explore the logic of the end of laissez-faire—as theory, as policy, and as the object of U.S. economic diplomacy. I contend that the pursuit of laissez-faire had much to do with American dominance of the noncommunist world in the years since World War II, and that in turn had much to do with the Cold War. Paradoxically, therefore, the collapse of Marxism and the end of the Cold War portend the end of laissez-faire, too. My subject is in a sense the *second* end of laissez-faire, for the ideal of a self-regulating economy seemingly had been dispatched once and for all after the bitter lesson of the global Great Depression, the ensuing World War II, and the explanatory power of Keynesian economics. The reader will note that I have borrowed my title from a short essay by Keynes written in 1926. The intriguing question is why the utopian vision of a pure market economy proved so potent—why it came back to life, after being so thoroughly discredited by events half a century ago and after most advanced nations successfully built their postwar societies very much in the

spirit of a mixed economy rather than a laissez-faire one. Most of this book is devoted to exploring that question.

The doctrine of laissez-faire, as explicated in Adam Smith's *Wealth of Nations*, holds that market economies, when left alone, are essentially self-regulating. Sellers, left to their own devices, will produce goods and services in response to the demands of buyers. The interplay of supply and demand will generate the right signals, in the form of prices, of what ought to be produced. Correct prices will "clear the market," as in an auction. The unfettered operation of the price system leads to an optimal allocation of resources and the most efficient possible distribution of production, based on the logic of specialization, in which each producer gets to do what he does best. The resulting distribution of income and wealth is also efficient, and hence implicitly just. Even Smith, however, recognized that government had a function in all this—in caring for the needy, in building public works, in education and public health, and in preventing merchants from conspiring against the public interest.

In the 215 years since the publication of *The Wealth of Nations*, modern economic theory has striven for a world even more utopian than Smith's. Although Keynes's *General Theory* had immense influence on policy, orthodox economists in the end absorbed the Keynesian critique of Smith's classical economic view only to the extent of admitting that entire national economies might find demand out of balance with supply (the realm of "macroeconomics"); they continued to cherish the idea that governments should not interfere with the price system. That meant disdain for regulation, for substantial public investment, for industrial policy, or for measures to allocate investment or redistribute income and wealth. If and when governments did intervene, their actions should be as "marketlike" as possible. Keynes was relegated to a footnote, in effect, and the majestic ideal of a self-regulating economy marched on. The equations grew ever more intricate, but the basic idea persisted. So if laissez-faire was sidelined by the Depression, by wartime planning, and by postwar recovery, it lived on in the hearts of economists.

The case against laissez-faire as a principle for operating a national economy has been made in a voluminous literature and in human experience. In brief, pure free-market economies can be criticized for their instability as well as for their inequity. As theory, the *locus classicus* of the counterargument is John Maynard Keynes. As history, it is Karl Polanyi, who saw the entire collapse of Western civilization after 1914 as resulting from the century-long utopian endeavor of substituting market relations, which are contingent and transitory, for a more reciprocal and sustainable organization of human society. Though laissez-faire capitalism professed to be liberalism itself, market relations carried to an extreme drove out

other necessary forms of relation and led to deeply antiliberal spasms of response. Laissez-faire, in short, wrecked the civil society on which capitalism depended. There is also, of course, an extensive Marxian literature that takes issue with classical capitalist economics. My quarrel, however, is not with capitalism itself, only with its utopian variation, and I quarrel in the spirit of Keynes and Polanyi.

\* If orthodox economists continued to harbor dreams of a self-regulating marketplace, practical statesmen carried the day in the postwar era, building modern welfare states, tempering the instability of a pure market system with both Keynesian management of total purchasing power ("aggregate demand") and a dose of national economic planning. In the United States, much of the planning was done under military auspices and the welfare state was less fully developed, but for the quarter century after World War II, Americans, like Europeans, practiced a mixed rather than a laissez-faire brand of capitalism.

\* My purpose here is not to reiterate the arguments against laissez-faire as the best principle for managing a domestic economy. There are entire libraries on the subject, and I have added my own observations in an earlier book, *The Economic Illusion* (1984). Rather, I am here concerned with the international economy, a realm in which the forces of private commerce are far more difficult to tame, for the obvious reason that the reach of the nation-state ends at its borders. One must look to the international realm to understand why laissez-faire rose from the dead, and to appreciate why American diplomats led the resurrection.

After all, for most of its history, the United States has pursued policies that went beyond simpleminded laissez-faire. Alexander Hamilton created a major economic function for government in banking and in industrial development. Thomas Jefferson, usually classed as the more classically liberal of the two, was also something of a planner. He made sure that the land-tenure policies of the young Republic favored small freeholders rather than large land speculators. Like Hamilton, he supported government policies to encourage the scientific, agricultural, and mechanical arts—the sum and substance of commerce of the day. Government also invested extensively in canals and railroads and in mapping new territories. And early America necessarily industrialized behind tariff walls; otherwise, it would have continued to be an economic ward of Great Britain.

To be sure, one can point to an opposite tradition: American culture has always been individualistic. Americans as a people are deeply ambivalent about government. Our nation began as a revolt against the British Crown. Our Constitution was a unique act of statecraft whose essence was limitation on state power. Unlike, say, Britain or Sweden or Japan, our nation was not a monarchy with a tradition of strong government that was gradu-

ally democratized and converted to public purposes without losing its ability to act in the national interest. Nonetheless, despite all of these unique cultural and historical antipathies, Americans still had a barn-raising tradition that often required surprisingly activist use of government for economic development purposes—even in Jefferson's day, not to mention the era of the New Deal—in programs as diverse as social insurance, homesteading, and public works.

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 America's intermittent enthusiasm for laissez-faire grew into a diplomatic obsession and a global ideal only after World War II, when the United States was the world's premier military and economic power. There is a logic to this stance: the nation best positioned to exploit its own commercial leadership becomes a crusader for the most open possible global markets in capital, raw materials, and finished goods and services; Britain, the leading nineteenth-century commercial power, had done this earlier. After World War II, the United States' commitment to laissez-faire as the principle for global trade was somewhat offset by the reality that Americans were practicing a mixed economy at home. If a mixed economy was necessary domestically to compensate for the imperfections of Adam Smith's invisible hand, it didn't make sense to strive for perfectly free markets globally. And in the 1940s and 1950s global commerce was still so encumbered by leftover wartime restraints—perfect free trade was such a long way off—that this latent contradiction was not yet a problem.

As the postwar era evolved, the balance of domestic political forces within the United States shifted. The elements of the Roosevelt coalition, which provided the constituency for a mixed economy, gradually weakened. The business community, which had been constrained politically both by the Depression and by government planning during the war, recovered its influence. The Vietnam War undermined the liberal coalition and set in motion an inflationary cycle, which discredited both Keynesian economics and liberal Democrats—the architects of a mixed economy. The OPEC oil price increases and the economic distress of the 1970s administered the coup de grace: a decade of turbulence could be blamed on Keynesian economics. When Ronald Reagan succeeded Jimmy Carter in January 1981, the marriage between political conservatives and laissez-faire economists was waiting to be consummated.

\* Unfortunately, however, the moment of laissez-faire came round again at just about the time the United States was losing its global commercial leadership. If it made pragmatic sense for America in the 1950s and 1960s to preach the freest possible markets, it made far less sense in the 1980s and 1990s. Yet by 1980, as laissez-faire hardened from self-interest into dogma, the world was turning into one big marketplace, outrunning the macroeconomic policies of individual nations. During the 1950s and 1960s, the poten-

tial instabilities of a global market system were tempered by the reality that the economic power of the United States and the American dollar gave ballast to the world economy; a quarter century later, that was no longer true. And the Cold War and U.S. military expenditures serving as instruments of planning and stabilization is a phenomenon that is fast vanishing as well. It has been more than half a century since the world economy tried to operate according to principles of laissez-faire—and the 1920s and 1930s hardly offer models to emulate.

\* The years ahead should be a post-laissez-faire era for several distinct reasons. First, there is the stability of the system itself. Thirty years of steady postwar economic growth and relative political stability is a record in the history of the world. But it depended to a large extent on the United States' hegemony, and far from being a unique force for global economic stability, the United States today is only one great power among many, a source of instability, and new stabilizing institutions are necessary. Economies are not self-regulating within any one nation-state, and they do not suddenly become so just because commerce and finance are globalized—on the contrary, when commerce and finance are genuinely global and economies more interdependent than ever, a free market is newly vulnerable. We need a new generation of countervailing institutions and processes, for reasons of efficiency and stability as well as equity.

Second, world commerce as practiced is already a far cry from laissez-faire, except in the minds of orthodox American economists and their political allies. It is wishful thinking to celebrate the collapse of communism as a victory for simple nineteenth-century economic liberalism. When the restive citizens of Eastern Europe contemplated the attractions of the West, they had in mind not Dickensian capitalism, but modern social democracies in which the citizen enjoys protections against the ravages of markets as well as the excesses of states. The successful, dynamic economies of the late twentieth century have never subscribed to the Margaret Thatcher or Milton Friedman brand of simple free markets. Japan, Korea, and other economically vigorous Asian nations use an explicitly developmental state; the instruments that safeguard social health are largely cultural, but certainly they do not have free markets in the Western sense. The European Community practices a mix of managed and free markets and is not at all reluctant to support farm prices, subsidize new commercial technologies, and condition free entry to its domestic markets upon reciprocal bargains. Even the most "conservative" nation of the EC, the Federal Republic of Germany, spends nearly half its gross national product in the public sector, and it offers its citizens generous universal welfare-state

support. Though commerce and finance in the late twentieth century are substantially globalized, our era is increasingly one of transnational joint ventures and consortia, heavily driven by technological learning and heavily influenced by state involvement. This is not the economy of Adam Smith or David Ricardo.

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If the United States could not export its conception of laissez-faire to the world at a time when its economy was supreme, it can hardly do so when its relative economic power is more modest. The end of the Cold War signals an end not only to Soviet dominance in the East but to U.S. dominance in the West. The coming of age of Japan and the European Community increases the influence of forces that neither preach nor practice U.S.-style classical liberalism, and the United States needs to come to terms with this reality.

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Third, there is the crucial matter of America's own national interest in an era no longer defined by the East-West geopolitical conflict. It is easy enough to declare that geopolitics must now give way to geo-economics. Defining what that really is, what conception of ideology and national interest applies, and what policies logically follow is rather more complex. That is the subject of much of this book. In a nutshell, my thesis is that America's devotion to laissez-faire as an ideal for either the U.S. economy or world commerce has become a serious hazard. It impedes the tasks of defining our strategic goals in the world, restoring our own economy to health, and organizing a sustainable, plural new economic order. The end of American hegemony does not have to signal the beginning of American decline. On the contrary, it ought to signal an opportunity for American national renewal.

The end of the Cold War invites a strategic shift in the economic as well as the military posture of the United States. The epochal changes in the Soviet Union and Eastern Europe come not a moment too soon, for the global grand strategy of the United States can no longer be sustained by the American economy. It has become conventional to assess the costs of the Cold War mainly as the economic strain of military leadership—Professor Paul Kennedy's "imperial overstretch." But as I shall argue, America's military leadership, its relentless promotion of laissez-faire, and the costs to its own economy are also linked in other, more subtle and complex ways.

Until the revolutionary events of 1989-90, the idea that the United States should revise its conception of national security to emphasize geo-economics rather than geopolitics had a certain logic, but it was a very difficult case to make in domestic politics. For even if the American economy was

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admittedly deteriorating, the high politics of Cold War remained paramount so long as Soviet policy seemed to threaten Western Europe, or peripheral areas of the world, or the nuclear balance. Moreover, the central role of the United States as propagator of the faith in liberal commerce made it awkward to commend economic nationalism as the policy of choice for the United States itself. As a result, politicians who favored any form of planning, or industrial policy, or "conversion" from military to commercial prowess, or a new emphasis on economic renewal, were dismissed, not as proponents of a dissenting school of political economy but as jingoists, simple protectionists, and geopolitical naïfs. Of course, the apparent "nationalism" of the dissenting view is not jingoist or anti-foreign, but simply a recognition that until world government arrives the nation state is the necessary locus of social contracts between market and society. As long as individual wealth is bound up with the wealth of a particular nation, then it matters immensely who produces what, and whether major nations play by the same rules.

The end of the Cold War and the dawn of many forms of pluralism unlock new possibilities. Pluralism in the former Eastern bloc means that the East-West balance ceases to be the defining strategic reality. And the economic coming of age of Western Europe and Japan signals a new pluralism in the West, which allows responsibility for the norms of the trading system to be shared, rather than being the prime responsibility of the United States. Yet at this writing, these dramatic changes have not yet produced fundamental reappraisal or initiative in U.S. geo-economic policy, other than a willingness to begin gradual arms reduction. The basic American conception of its global interest tenaciously resists revision.

Since the late 1940s, the American stance in the world has been built on two bedrock premises: that communism must be contained and that world commerce and finance must be organized according to principles of laissez-faire. The corollary of resolute anticommunism seemed to be an equally fierce unreconstructed capitalism. This symmetry of anticommunism and pro-laissez-faire may seem so obvious as to be axiomatic, but its dynamics are complex and worth investigating. Western Europe and Japan, after all, are also resolutely anticommunist but have never crusaded for classical economic liberalism, nor have they habitually sacrificed their own economic well-being to promote system-wide goals. However, for the United States, the Cold War and the laissez-faire imperative were mutually reinforcing—in several respects.

Geopolitically, an anti-Soviet grand alliance under American auspices engendered a satisfying deference to the United States among the liberal capitalist nations. On matters of "high politics"—national security—America's allies tended to follow its lead. The United States, in turn, paid

for its leadership by bearing a disproportionate share of the costs of the Cold War. On economic matters, the United States took the lead in promoting an ever greater liberalization and integration of the global market system. But as guardian of that system, it was constrained, paradoxically, to tolerate a good deal of covert mercantilism among its trading partners and to subordinate its own national economic interest to free-market goals for the system as a whole, which it viewed almost as an extension of itself. Dollar hegemony, likewise, offered geopolitical benefits but escalating economic costs.

It was not surprising, therefore, that many officials in the Bush administration at first expressed real unease bordering on nostalgia when the Cold War began to end. For, as Deputy Secretary of State Lawrence Eagleburger declared poignantly in a lecture of September 13, 1989, at Georgetown University, these twin goals—containing communism and promoting American-style capitalism—had offered a certain security and predictability, as well as a reliable hierarchy of foreign-policy goals. "For all its risks and uncertainties," said Eagleburger, "the Cold War was characterized by a remarkably stable and predictable set of relations among the great powers."

Geopolitics after World War II was at its core about limiting the reach of the Soviet Union. That goal became so fundamental to American diplomacy that policy operated almost reflexively and provided a dependable calculus of American national interest. Peripheral conflicts were deemed significant mainly on the basis of whether they helped or harmed the Soviet Union. Our ostensible commitment to liberal capitalist democracy could be subordinated to accommodate fairly nasty right-wing regimes (in Chile, El Salvador, South Africa) and even wayward communist ones (Yugoslavia, China, Cambodia) so long as they blocked Soviet expansionism. In the American political mainstream, the only serious policy disputes of the Cold War era all hinged on whether the Soviet connection in a given regional conflict was strong enough to justify U.S. intervention (Vietnam, Cuba, Nicaragua). Seldom did we debate whether these conflicts intrinsically threatened our own national security, and never whether Russia itself should be contained. That bedrock goal was bipartisan and beyond dispute.

The logic of the postwar system also offered a hierarchy of geo-economic goals. These were less explicit, understood more intuitively, and seldom examined or challenged. America's own economic power was assumed as a given. Explicit industrial goals were eschewed as unnecessary, as contrary to our stated ideology, and as a bad example for our trading partners. Hardly anyone acknowledged or addressed the contradiction between

only globally. American manufacturers and bankers saw advantage for the leading capitalist nation in the freest possible movement of goods and money. And U.S. diplomats were pleased to offer America's Cold War allies the prize of free entry to the world's biggest market. The two goals complemented each other perfectly.

Both ideology and geopolitics reinforced the nearly fanatical loyalty to "free trade" that has characterized the members of America's bipartisan foreign-policy establishment. Yet this logic led the United States into policy dead ends, bad for the U.S. national interest and confusing for the global trading system. The prevailing ideology of economic liberalism has eschewed having industrial goals in the United States: in principle, it is none of the government's business where steel, or automobiles, or semiconductors, or VCRs, or civilian aircraft are produced; if production migrates abroad, this must be the market speaking, and if foreign industrial policies are the guiding, not invisible hand of global markets, this is deemed to make no significant difference. In practice, this makes America's industrial fate partly the captive of other nations' industrial strategies. Yet classical trade theory holds that if other nations are stupid enough to subsidize their export industries, American consumers ought to welcome the gift. The continuing disdain for having national industrial objectives makes it impossible to have any U.S. trade goals either, other than to exhort other nations to practice laissez-faire in the American image.

The United States continues to view itself as the political leader of the Western world, but U.S. administrations are reluctant to force other nations to play fair, lest they alienate key geopolitical allies. When exhortation fails to achieve equitable results, or to open markets, they are reluctant to resort to explicit market-share remedies, because this, of course, would be a version of the managed trade they claim to disdain and would violate the very ideology they promote. Finally, perhaps most seriously, our devotion to the ideal of laissez-faire means that those departures from liberal trade which do intermittently occur are undertaken guiltily and without strategic purpose, and are considered unfortunate concessions to domestic politics rather than economic development initiatives.

If our trading partners at least appreciated us as the only good free trader in the system, that might be a worthwhile outcome, but they don't. To most of the world, the theory seems utopian and the practice hypocritical. America seems to practice a chaotic ad hoc mercantilism—weapons procurement, farm price supports, textile quotas, and various "voluntary" restraints extracted from trading partners—while it stridently preaches free trade.

The United States after World War II enthusiastically embraced the role of, in Professor Charles Kindleberger's term, geo-economic "hegemon," much as Britain did in the middle and late nineteenth century. In Kindleberger's "theory of hegemonic stability," first spelled out in 1973 and since embellished by Stephen Krasner, Robert Keohane, and John Ruggie, among others,<sup>1</sup> the global economy tends to be systemically unstable, for much the same reason that an unregulated domestic economy is unstable. An unstabilized market economy is vulnerable to cycles of overproduction and underconsumption, as well as to panics that originate in the financial sector, which in turn lead to monetary contractions that only reinforce the macroeconomic propensity to boom and bust, as they spread to the "real" economy.

Domestically, this tendency could be leavened by activist macroeconomic policy, as well as interventionist central banking and other regulatory measures intended to contain financial instability. These could be explicitly Keynesian, via appropriate public budget deficits and surpluses; or they could involve an implicit Keynesianism of countercyclical military spending, social insurance, and multiyear union contracts, all of which serve to stabilize purchasing power across the business cycle.

But internationally, there is no Keynesian mechanism because there is neither a central monetary authority, a central currency, nor a central government capable of enforcing a common macroeconomics. There is also a proclivity for individual nations to solve their domestic economic problems by periodically deflating or by resorting to mercantilist devices, both of which restrict the market for other nations' products. The laissez-faire tendency to overproduction, to competition based on cheap wages, and to a resulting shortfall in aggregate demand is only intensified when nations attempt, strategically, to capture advantage in particular products at the expense of other nations. The classical liberal remedy for the multiple dilemmas of global commerce is simply free trade. But free trade by itself does not solve the Keynesian problem and may in fact worsen it.

Kindleberger and others have suggested that in the absence of a world government the global economy can be stabilized when a powerful nation plays the role of flywheel. The hegemon, in this conception, performs several functions: it serves as quasi-central banker, providing the system with financial liquidity in times of stress, as well as credit to temper exchange-rate instability; it serves as market of last resort and encourages other nations to keep their markets relatively open; being a rich and technologically advanced nation, the hegemon is a net source of development capital as well; and it also has a special responsibility for keeping the peace. A hegemon, in Kindleberger's sense, is relatively benign. Affiliation with its system is not coerced, but invited on the basis of benefits that the

hegemon offers other member nations. Indeed, what differentiates hegemonic leadership from Caesarism is precisely that the hegemon uses carrots rather than sticks and makes sacrifices to preserve the system. Chief among these is that the hegemon endeavors to be the system's best-behaved free trader.

The nineteenth-century version of this system worked roughly as the theory describes, though it coexisted with such anomalies as empires, as well as German, French, American, and Japanese protectionism. It also had the notable disadvantage of being based on a gold standard, which achieved stability at the price of periodic deflation and left financial liquidity dependent on the vagaries of new discoveries of gold. After World War I, when a weakened Britain ceased to be the world's central banker and a hesitant United States was not yet willing to play the role, dissension and eventual anarchy reigned. The system slid toward depression and autarky, followed by crude nationalism and war, precisely because it lacked a benign hegemon.

✓ The trouble with the hegemonic role is that over time it takes a toll. In the nineteenth century, Britain gradually got into the habit of exporting capital rather than goods, which depleted its own industrial base. In the spirit of Cobden and Peel, it practiced unilateral free trade; even nations with protective tariffs could export freely to England, just as the theory of free trade commended. Gradually, Germany and post-Civil War America, which were protectionist, caught up with and surpassed Britain's industrial productivity. After World War I, Britain briefly endeavored to retain the hegemonic role despite immense debts, and attempted to value the pound at its prewar parities, severely deflating its economy. Its military outlays also exacted both a direct fiscal toll and an indirect one in the militarization of much of its industry.

Of course, the hegemonic role confers benefits as well as burdens, and let us pause for a moment to note them. To begin with, the hegemonic role is immensely satisfying. If your nation is the leading one, it means that your currency is as good as gold, and other nations' currencies tend to be cheap in comparison. The hegemon characteristically permits other nations' currencies to be slightly undervalued, in order to temper its own payment surplus. Its allies, looking to expand exports, appreciate this, which in turn reinforces their deference to the hegemon. In the first three postwar decades, American GIs, tourists, and businessmen were delighted to find Western Europe a place where it took only a few dollars to buy fistfuls of local play money. A presentable meal cost five shillings in London or six francs in Paris, sailors could find sexual entertainment for the cost of a pair of nylon stockings, and the American middle class could actually tour Europe on the incredible pittance of Five Dollars a Day. Americans had

the further satisfaction of seeing English become the lingua franca. The American abroad enjoyed a privileged status, and could generally be bailed out of any minor trouble by the local U.S. consulate.

As long as the hegemonic economy has a large capital surplus and the most productive manufacturing base, the world is an oyster for the hegemonic industrialist. After World War II, American entrepreneurs and bankers, armed with dollars and with that self-consciously American resource "know-how," spread out to all corners of the globe in search of markets. Rather than exporting products from high-wage America (which would have been churlish, given America's towering trade surplus), they set up shop locally, bearing financial and physical capital for local development. As late as 1967, the French journalist Jean-Jacques Servan-Schreiber could warn of an insurmountable *défi américain*, made up of U.S. capital and technological and entrepreneurial supremacy. The notable exception to this pattern, interestingly, was Japan, which largely closed its borders to American capital and American industrial investment, much to the consternation of U.S. economists, who offered grim warnings that poor Japan was shooting itself in the foot.

The hegemonic nation also gains a variety of political and economic advantages from being the provider of the system's key currency. That currency, by definition, is typically the system's "hardest" currency, the one treated with the most respect in the world's money markets. The technical literature terms this special advantage "seigniorage," in an updated usage of an archaic term that originally meant the profit that the sovereign makes for his own treasury from minting the coin of the realm. As applied to global political economy, seigniorage refers to the extra benefits of monetary hegemony. The seigniorial nation, for example, is able to borrow from abroad in its own currency, leaving other nations with the exchange-rate risk of possible devaluation. The monetary hegemon, uniquely, can print extra currency to cover payments deficits, leaving trading partners with imported inflation. Its currency is the one used for most commercial transactions, which gives its bankers advantage. Even at moments of extreme payments imbalance, America never had to submit to the indignity of IMF stabilization reviews, as did such once-mighty nations as Great Britain. For the most part, the seigniorage of the dollar was borne stoically by America's allies, as part of the recompense for American responsibility for the collective defense. The notable exception was General de Gaulle, who publicly railed against what he called the "exorbitant privilege" accorded dollar seigniorage, and uniquely among the leaders of allied nations deliberately exchanged dollars for gold in order to undermine the dollar's dominance.

Needless to say, the supremacy of the dollar in such institutions as the

IMF and the World Bank, as well as the dollar's role as principal currency both in commercial transactions and in the official reserves of nations, also gave the United States political benefits. American geopolitics—with the United States considered the bulwark against Bolshevism, the nation that viewed anticommunism in the most sacred terms—gave the United States further reason to value the diplomatic leverage conferred by its economic hegemony. Only in the 1960s, for the first time, did a major European ally (France) cross the United States on a fundamental question of East-West strategy. And General de Gaulle's insistence on developing an independent French nuclear *force de frappe* was notable mainly because it was so exceptional. Britain and West Germany, by contrast, generally did America's strategic bidding where the East-West strategic balance was concerned. Differences openly arose only over policies toward peripheral areas—the Suez invasion (in which Britain and France were humiliatingly made to back down); Vietnam (where the United States got less than the deference it wanted); the Falkland Islands (where the British lion indulged in one last atavistic imperial roar).

Until only a few years ago, the United States essentially ran the IMF, the World Bank, the GATT, the Coordinating Committee on Multilateral Export Controls (CoCom), NATO, and other nominally international agencies of hegemony, usually through foreign national surrogates. This meant that its preferred financial policies, as well as its geopolitical politics, were most likely to carry the day. All of this suggests why hegemony, once experienced, is so very hard to give up—even when its costs are excessive.

\* In the revisionist memory of orthodox economists, the postwar reconstruction that began at the Bretton Woods conference of 1944 was nothing more than the restoration of classical economic liberalism, based on free movement of capital and goods. But at the time, the goal was seen as something else entirely. The statesmen of the 1940s were activists. They were mindful of the need to invent an alternative to the two extremes that recent history had burned into their consciousness: the escalating instability of laissez-faire capitalism during the 1920s and the destructive retreat into autarky and currency blocs during the 1930s, which in turn led to popular revolt against democratic rule, to extreme nationalism, and to a second world war. The postwar system, in John Gerard Ruggie's nice phrase evoking Karl Polanyi, was not intended to be classical liberalism but rather "embedded liberalism"—a market economy acknowledging social realities and tempered by stabilizing institutions.<sup>2</sup>

As we shall see in Chapter 2, none of the architects of postwar recovery on either side of the Atlantic placed much credence in laissez-faire. The

Great Depression had discredited the idea that markets were self-regulating. The war had demonstrated the power of economic planning and the possibility of full employment. Virtually every Western leader of republican conviction, whether nominally Social Democratic, Christian Democratic, plain Democratic, or even high Tory, believed government had a major function to perform in the economy, as stabilizer, as planner of public investment, as guarantor of high employment, as arena of social bargaining, and as custodian of a benign welfare state. In 1944, the statesmen of Bretton Woods attempted to design a world economic order biased toward full employment and high rates of growth.

The Keynesian remedy was to share a degree of sovereignty with a new global monetary authority. Nations might borrow liberally from that source to cover temporary payments deficits, rather than responding in the traditional way by deflating. The Keynesians hoped that this regime would both permit domestic economic policies of full employment and gear the international system as a whole toward plentiful credit and rapid growth. To the extent that the Keynesians were qualified free traders, they considered the systemic commitment to high growth, planning, and full employment necessary to make porous domestic markets politically enduring. In the absence of such a global regime, nations might have to limit free movement of capital and goods in order to practice Keynesianism-in-one-country.

But to borrow from T. S. Eliot, between the conception and the creation fell the shadow. Once Roosevelt died and the war ended, neither the Truman administration nor the Congress was prepared to cede that degree of sovereignty to international institutions, least of all to institutions likely to be dominated by foreigners of dubious collectivist persuasion. The actual International Monetary Fund turned out to be rather more modest, partly because forces of financial orthodoxy had regained influence in both Britain and America and partly because of the concerns about sovereignty. A parade of bankers, led by the president of the New York Federal Reserve Bank, Benjamin Strong, testified against the already watered-down IMF design for a global regime based on cheap credit, which seemed reminiscent of cranky nineteenth-century populist monetary schemes. In 1946 and 1947, the United States retreated from its bold commitments to a new global financial order, and Europe descended into recession. What rescued global Keynesianism—of a sort—was the Cold War.

American power came to be the stabilizer that was briefly envisioned for the IMF and World Bank. The dollar, not Keynes's imagined reserve currency "Bancor," gave the system liquidity and a bias toward growth. The Marshall Plan and America's Cold War spending, not a large-scale World Bank, balanced America's chronic export surplus and provided

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capital for postwar reconstruction. On paper, a degree of sovereignty had passed to a new generation of supranational bodies that seemed to be a vast improvement upon the frail institutions of the Versailles regime. But in practice, the U.S. Congress was willing to cede such authority only because the new international institutions were well understood to be proxies for the United States.

There was now a sharp disjuncture between the forms of a moderately Keynesian global regime, the geopolitical realities, and the understanding of what had been ventured. Though the global economic system invented in the mid-1940s was emphatically a mixed regime, with Keynesian and social democratic stabilizers, the regime's guarantor, the United States, paradoxically had the least enthusiasm for either abandoning classical liberalism or ceding sovereignty. Thus, the very departures from laissez-faire that helped to anchor a mixed system were not entirely acknowledged by the system's prime sponsor. Conservative Americans accepted nominally supranational institutions only because they were surrogates for American power. They tolerated restrictions on the free flow of capital and goods only as transitional measures necessary for early postwar reconstruction. They accepted the Keynesian welfare states of Western Europe as necessary anticommunist allies, not as ideological soul mates. And when laissez-faire was fashionable again, and private capital became fully mobile, and planning fell into disfavor, it was in the United States that the resurrection of classical liberalism was greeted with special glee—for this supposedly was the ultimate aim of American doctrine.

Yet as the ethic of laissez-faire gained ground, it did so almost in lockstep with the relative decline of its prime sponsor, the United States of America. America's endeavor to inject its own norms into the policies of other nations and rules of the trading system, while retaining its own status as system leader, came at increasing cost to its own (poorly understood) national interest. As other industrial nations gained strength, the cost to the United States of maintaining American hegemony escalated. However, American leaders were reluctant to alter their fundamental global policy objectives so long as Soviet communism was a perceived and often real security threat. With the ascendance of Ronald Reagan, the twin commitment to laissez-faire economics and anti-Sovietism as the fundamental policy goal intensified, and so did the costs to the U.S. economy.

The history of this deepening crisis is discussed in Chapters 3 and 4. The costs of hegemony have been conventionally understood mainly in military terms, as the unsustainable fiscal expense of maintaining a military protectorate. In official circles, there is long-standing clamor for "burden-sharing" of military costs with U.S. allies. But that analysis overlooks two other kinds of costs that directly flow from America's hegemonic role—the

structural costs to domestic industry, which are discussed in chapters 5, 6, and 7, as well as the macroeconomic strains of supplying the world's currency and serving as engine of world demand, which is treated in Chapter 8.

The structural costs include the penalties that America incurs as the necessary exemplar of laissez-faire trade. America permits itself a closet form of strategic industrial planning only as an incidental by-product of military spending. Most government-sponsored R&D outlays are funneled through the defense establishment, compared with less than 10 percent in Germany and Japan. Commercially oriented industrial targeting, of the sort practiced by both Japan's Ministry of International Trade and Industry and the European Community, is ideologically verboten, and can be accomplished only incidentally. American trade negotiators chronically find themselves in the ludicrous position of earnestly denying that U.S. supremacy in aircraft has anything to do with the trillion dollars expended on purchases for the Air Force. The end of the Cold War drags all of these issues out of the closet. The United States now must face head-on the ideological questions of what deliberate technology policy we desire, to what national ends, and subject to what global ground rules.

Oddly enough, for a decade the United States has preached an ever more devout adherence to laissez-faire while practicing a perverse, unacknowledged Keynesianism, at ever-escalating cost to its own well-being. With much of the world suffering from debt, high unemployment, and stagflation, the one source of fiscal stimulus to the global economy was the U.S. budget deficit, which contributed extra purchasing power to the world economy—at long-term cost to America. As Japan and West Germany tended their own gardens and fiercely resisted the pressures of imported inflation, the dollar remained in its anomalous role as global currency. In theory, Reaganism preached an economics of free markets and fiscal restraint. In practice, Reaganism offered a fiscal stimulus to the United States and the world, driven first by increases in military spending and later by a structural deficit borne of tax cuts.

Supposedly, the post-1973 regime of floating exchange rates would force each nation to bring its macroeconomic policies into harmony with those of trading partners or suffer runs on its currencies. But the United States, as monetary hegemon, was the one nation able to borrow in its own currency. It was thus oddly exempt from the discipline, at least in a short run that turned out to be distressingly long. By the early 1980s, foreign capital flooded into U.S. money markets, attracted by Federal Reserve chairman Paul Volcker's monetarist anti-inflation remedy of double-digit

interest rates. This, of course, bid up the value of the dollar. A high dollar, in turn, abruptly priced U.S. goods out of world markets—just when the productive strength of rival economies was also making U.S. goods less competitive.

But thanks to this hegemonic exemption, as the U.S. balance of payments deficit widened and the trade accounts worsened, the value of the dollar, instead of going down, kept going up. American products were ever more uncompetitive, while the first Reagan administration kept insisting that the “free market,” by definition, had to be getting the value of the dollar right and that there was no problem. A high budget deficit exacerbated the problem by requiring the United States to suck in even more foreign capital. A related ideological stubbornness—a dedication to low taxes and high military spending—precluded a macroeconomic remedy.

When, early in the second Reagan administration, Treasury Secretary James Baker belatedly conceded that markets could indeed be getting the value of the dollar wrong, the strategy changed but the larger ideology did not. The Plaza Accord of September 1985 committed the five leading nations to a rough management of exchange rates and a coordinated effort to drive down the value of the dollar. However, the “Group of Five” (the United States, Japan, West Germany, Great Britain, and France) stopped well short of devising a new Bretton Woods or constructing an expansionary solution to the Third World debt. It was a moment that cried out for bold statecraft, but the leaders of every major capitalist nation save France were conservatives who did not believe that markets required major structural interventions. The traditional policy goals of the United States—ever greater deregulation and liberalization of the global system and disdain for policies of economic stabilization or industrial targeting—were reemphasized.

A cheap dollar coupled with persistent budget deficits failed to solve America’s trade imbalance. Contrary to standard theory, the structural damage to U.S. competitiveness caused by the period of dollar overvaluation did not instantly reverse itself when the dollar cheapened. At the end of the 1980s, the U.S. trade deficit was still in excess of \$100 billion a year. Nations eager to hold the market shares they had captured proved very adept at “pricing to market” and compensating for the cheaper dollar. When the yen appreciated 50 percent against the dollar, the price of Toyotas did not rise proportionally. Despite a macroeconomic imbalance, the United States was able to import the capital it needed to finance its budgetary and trade deficits, but it did so more and more by selling real assets. With its twin deficits, it therefore continued to be a Keynesian engine sustaining a moderate pace of global growth—but at escalating cost to its own economic health.

There is an orthodox account of the cause and cure of America's economic slide, and a dissenting account. The orthodox account is the product of an extremely potent alliance—of Cold Warriors, private capitalists, and traditionalist economists. The Cold Warriors like American markets to be as open as possible because this is part of the glue of alliance, in which the low politics of trade takes second place to the high politics of national security. When U.S. priorities place geopolitics ahead of geo-economics, America's trading partners are only too happy to oblige. The private capitalists like global laissez-faire for the obvious reason: they wish to pursue markets, materials, and earnings wherever they choose and to escape the discipline of national regulation. Orthodox economists complete the triad by preaching that the least regulated market is the most efficient one, and they certify the scientific soundness of laissez-faire. Neoclassical economists, industrialists, and investment bankers flow in and out of government jobs, where they share the premises of the Cold Warriors about America's hegemonic responsibilities. American industry, in turn, supports researchers known for respectable, internationalist thinking, which is to say laissez-faire. All these links create a club of like-minded people that marginalizes or excludes heretics.

In the orthodox account, America's industrial decline is mainly the result of macroeconomic factors—a low savings rate, an excessive budget deficit—which in turn require domestic interest rates to be too high and suck in foreign capital. Standard economics insists that structural factors such as industrial organization, technology policy, public investment, and training systems only barely affect the competitiveness of nations and in any case cannot (by definition) improve on the market. The standard account holds that it would be self-defeating for America to respond to its worsening competitive standing by resorting to sectoral policies or strategies of managed trade. Such measures are dismissed as wrongheaded theory, as self-serving pressure from injured interest groups, and as irritating to allies.

The orthodox school also holds that foreign investment in the United States is an unambiguous blessing, and that concern about foreign ownership of factories, farms, real estate, and proprietary technologies is anachronistic in a globalized economy, if not nativist. Finally, it insists that trade policy, again by definition, can make no difference. If the United States turns up the diplomatic heat and coerces Japan to buy more supercomputers, say, American consumers will compensate by purchasing some other import so long as the macroeconomic fundamentals are unchanged; the same trade balance will persist.

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The dissenting account of America's economic predicament is less neatly packaged and less ideologically coherent, but it is rapidly gaining credibility. It emphasizes that a variety of structural factors—including the dynamics of American capital markets, the organization of American firms, the short-term perspective of American investors, the quality of American schooling and job training—have combined to hobble the competitiveness of U.S. industry. It doesn't deny that savings rates, budget deficits, and the value of the U.S. dollar matter, but it insists that they don't tell the whole story.

Ideologically, the dissenting camp is diverse. For example, business leaders frustrated by Japanese mercantilism find the macroeconomic account of America's declining competitiveness unconvincing. Trade unionists find that the integrated global economy is relentlessly undercutting good jobs at good wages. Most specialists on Japan find the economists' denial of Japan's intricate mercantilism absurdly deductive; empirical studies of the structure of the Japanese economy have identified a complex web of relationships that effectively resists imports. This emerging view is ideologically inchoate, for some of its most provocative representatives (Clyde Prestowitz, Chalmers Johnson, Kevin Phillips, among others) consider themselves essentially conservative Republicans, while others (Lester Thurow, Robert Reich, Laura Tyson, and James Fallows) are liberal Democrats. They have something basic in common, though they haven't quite acknowledged it: they don't believe in laissez-faire.

Until very recently, the logic of American hegemony, both as protector of military security and as advocate of global free markets, was so potent that the dissenters could not receive a serious hearing. When it comes to trade policy, most Democratic economists as well as Republican ones are resolute defenders of classical liberalism. In the last Democratic incumbency, the most potent opposition to both industrial policy and aggressive trade policy came from within the administration, not from the Republican opposition. Politically, the ascendancy of laissez-faire and the disrepute of Keynesianism have caused candidates with interventionist instincts to couch their views mainly in terms of having to get tough with America's trading partners. In the 1988 election, the press treated Richard Gephardt as a simple Japan-basher, and not as a candidate offering a different theory of political economy, and Gephardt himself was not quite sure just what his dissenting theory might be.

But all of this is at last changing, and rapidly. The old laissez-faire iron triangle of industrialists, diplomats, and economists is wobbling. Industry is no longer unanimously supportive of the laissez-faire agenda, and the skepticism goes far beyond the "loser" industries of the orthodox account. America's most advanced manufacturing industries are now supporters of

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both a more collaborative relationship between industry and government and a more assertive approach to trade. The Bush administration may not care whether America's last large manufacturer of semiconductor fabricating equipment is sold to the Japanese, but IBM cares, even though IBM is the quintessential "internationalist" American company. The principal lobbyist for disbanding export controls is now the U.S. Chamber of Commerce. And for the diplomats, with the Cold War ebbing, the East-West conflict ceases to be the overriding determinant of policy. Even the economics profession has made room for a dissenting view of trade, as well as giving grudging recognition to the truth that the organization of the firm, and of financial markets, and of educational and training systems, do affect a nation's ability to compete.

If the Cold War ended on November 9, 1989, the day the Berlin Wall came down, the post-Cold War era began on August 2, 1990, the day Iraq invaded Kuwait. The Mideast crisis that ensued signaled the outlines of a new geopolitical order in several ways. It suggested a concert of great powers, essentially status quo nations that believe in liberal capitalist democracy, upholding world order against a small group of nations with radical, system-threatening aims. It suggested that the Soviet Union, eager to ingratiate itself with Western powers and giving priority to its own economic recovery, would behave like a status quo power. It was startling to hear spokesmen for the Soviet Union—which after all had annexed Estonia, Latvia, Lithuania, and portions of Finland, Poland, Germany, Romania, and Czechoslovakia in the 1940s, which had invaded sovereign Eastern European nations as late as the early 1980s—railing against Iraq's aggression and defending the sanctity of national borders. And, remarkably, the United Nations, so recently attacked by U.S. administrations, was used to American advantage as an instrument of collective security.

At the same time, the Kuwait crisis underscored the United States' continuing image of itself as a hegemonic power while its major allies retained the habit of acting as free riders on the system. It was the U.S. that took the diplomatic lead, engineered the Security Council resolution, persuaded the Saudis to let in U.S. troops, urged the Egyptians to form an anti-Iraq bloc within the Arab League, and coordinated the embargo. It was the United States that initially committed ground troops. Japan, long accustomed to viewing its global interests in purely commercial terms and reluctant to alienate any trading power, had to be pressured into honoring the blockade of Iraq. America's NATO allies committed only token naval and air forces and resisted sending ground troops. The U.S. was hesitant to gear up the machinery of the United Nations as the vehicle of military

action, and, as hegemon, remained the key source of electronic intelligence on Iraq's battle plans and troop movements.

So, the system still tends to operate, by default, as a Pax Americana, and will continue to do so as long as the U.S. allows it to. Yet, with the Cold War over, for the first time since 1944 there is now an opportunity to build a true multilateral system. We have come full circle back to Roosevelt's vision of a system of collective security using international institutions anchored by great-power cooperation. Geopolitically, there is no need for the world's major nations to spend upward of a trillion dollars a year on an East-West arms race. The new challenge is how to prevent proliferation of chemical and nuclear weapons, and how to contain and mediate regional conflict, in the absence of an alliance system.

Economically, the challenge is also the one identified in 1944 by Keynes: how to gear the world toward high growth and full employment, and how to reconcile national sovereignty with a global marketplace. In the late 1940s, the United States was reluctant to cede sovereignty to international institutions because it was so strong; empowering organizations controlled by foreigners seemed an affront. Today, there is resistance to a new round of institution building because America seems too weak. It is easier to cling to the habits of American economic hegemony, and the false ideal of laissez-faire, even as those illusions corrode America's own well-being.

But to rebuild the world system and to redefine America's national strategy within that system requires the same boldness and imagination as possessed by the statesmen of 1944. First, we need to acknowledge the reality of pluralism. One hopes, contrary to Professor Kindleberger, that the role of hegemon can be played by a concert of great nations, for no single nation currently has the combined political and economic stature to do the job single-handedly. Such a system would require nations to pool sovereignty and financial authority in several functional areas: in an international trade organization with real enforcement powers; in a genuine global public central bank or regional banks with a Keynesian bias toward high growth.

U.S. influence in the Bretton Woods generation of monetary institutions is fading. Instead of clinging to the perquisites of former hegemony, we should welcome that shift. In exchange for letting Europe and Japan have more influence (which is coming anyway), we should insist that they take on more responsibilities. At Bretton Woods, Keynes rightly attempted to structure incentives that would force nations with chronic surpluses to expand, rather than placing the burden on debtor nations to deflate. It is unacceptable that a few nations, such as Germany and Japan, should run immense trade surpluses year in and year out. As chronic surplus nations, they enjoy high-employment economies with tight monetary policies, low

real interest rates, and low inflation. That intensifies the competitive advantages enjoyed by their firms, and it exports deflation to other nations. Japan and Germany (and of course Germany is now the leading nation of a larger entity, the European Community) have come of age, and they should shoulder more responsibility.

We need to acknowledge that laissez-faire is a false idol, for both domestic and global political economy. The global intelligentsia may think of itself as stateless, and global capital may see nation-states as anachronistic encumbrances. But the state remains the locus of the polity, notwithstanding the best successes of supranational institution building. And the polity remains the structure best suited for counterbalancing the excesses of the market. Therefore it does matter if American workers have access to high-productivity jobs, and it matters whether enterprises that provide those jobs are located in the United States. The EC, for example, is right to insist that foreign-owned companies that operate within Western Europe as "European" companies meet some threshold tests, such as whether they produce "high end" components in Europe or merely slap together final assembly. This may strike some purists as distastefully mercantilist, but until the millennium of global government comes or until all nations have roughly the same labor and social standards, it is a necessary accommodation to the reality of political economy. The United States would do well to address explicitly which key industries it hopes to retain and what mixture of foreign-owned and domestic companies is appropriate. One pursues such policies not because one dislikes foreigners but because the invisible hand does not produce equitable outcomes and the visible hand remains a national one.

\* Somewhere, in between the failed utopias of pure socialism and pure laissez-faire, a practical middle ground exists where economies can operate dynamically and civil society can flourish. It was the challenge of the generation of the 1940s to rebuild liberal society and keep totalitarianism at bay. It is our challenge, half a century later, to renew the promise of a mixed economy and a social conception of citizenship. In the coming decades, we will live in a post-Cold War world, which no great power will dominate. It is likely to be a post-laissez-faire world as well.

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