Conservatism and the Crisis: A Transatlantic "Trilemma"

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I

Ladies and Gentlemen, It is an honour to be invited to give this lecture, named in honour of Derald Ruttenberg, not only a generous benefactor of the Centre for Policy Studies, but also a lover of Scotland. I do not hold it against him that he was a Yale man not a Harvard man.

Scotland versus England; Harvard versus Yales: Life's dilemmas are easier than its trilemmas. To choose between two options can be hard. But it's often harder if you have to choose two out of three things.

The word trilemma originates in logic as a syllogism in which the choice has to be *one* out of three things. The most famous example was made popular by C.S. Lewis in his book *Mere Christianity*, though it was more pithily expressed by the nineteenth-century Scots preacher John Duncan, who put it like this: "Christ either deceived mankind by conscious fraud, or He was Himself deluded and self-deceived, or He was Divine. There is no getting out of this trilemma." But this is not the kind of trilemma I have in mind. In really difficult trilemmas we have to choose any two out of three more or less appealing options. We cannot have all three.

A good example which I have often heard from some feminists of my own generation is that a woman has to choose two out of the following three things:

1. A successful career;

2. Children;

3. A happy marriage.

She may try, but she cannot have all three.

The “trilemma” in economics (which I think was first defined by the British economist Alan M. Taylor) states that a country can have any combination of two of the following three things, but not all three:

1. Openness to international capital flows;

2. A fixed exchange rate;

3. An independent national monetary policy.

The British Conservative Party found this out the hard way in 1992, when the Major government tried and failed to have all three. Pegging the pound’s exchange rate with the deutschmark at a time when the British economy was in recession – with house prices plunging, as you may recall – while hedge fund managers like George Soros were entirely free to make huge leveraged bets against the Bank of England: this was neither a wise nor a sustainable policy, as some of us pointed out at the time.

It is worth looking back on the errors of that period, because in my view they condemned the Conservative Party to more than a decade in opposition. After September 1992, despite the recovery that followed the devaluation of sterling and the return of monetary independence, the Tories never wholly regained the ground they had lost in the opinion polls as a result of the ERM debacle. Their reputation for economic competence had gone because they had not understood the trilemma.

Few British Conservatives saw the events of 1992 in quite that light. For many in the party, the United Kingdom’s exit from the Exchange Rate Mechanism was in fact a vindication of their free market principles. As Margaret Thatcher famously put it, you simply could not “buck the market”. I want to suggest, however, that this was to underestimate the magnitude of the challenge posed to conservatism by financial globalization.

II

Already in 1992, the Bank for International Settlements estimated that daily turnover on the world's foreign exchange markets in 1992 exceeded $1 trillion. At that time, the combined international reserves of the British, French and Italian central banks were less than $150 billion. Soros alone was able to bet $10 billion that sterling would be devalued. As many other speculators followed where he led, simple arithmetic made it clear that the Bank of England would be overwhelmed, no matter how high it raised interest rates.

In the fifteen years between 1992 and the global financial crisis that began in the summer of 2007, the imbalance between financial markets and governments grew even greater. In 2006 the measured economic output of the entire world (global gross domestic product) was around $48.6 trillion. The total market capitalization of the world's stock markets was $50.6 trillion, 4 per cent larger. The total value of domestic and international bonds was $67.9 trillion, 40 per cent larger. Every day $3.1 trillion changed hands on foreign exchange markets – triple the volume in 1992. Every month $5.8 trillion changed hands on global stock markets.

Underlying the tremendous growth in financial markets was a fourfold liberalization of international markets for goods, services, capital and labour:

1. In 1990 the total value of trade was less than 40 per cent of global GDP; by 2004, although the world economy had grown by 50 per cent, trade had grown even faster – at an annual rate of 7 per cent – to equal 55 per cent of global GDP.[1] In the case of the United Kingdom, which has historically been a relatively open economy, exports and imports each averaged around 26 per cent of GDP in the 1970s, 1980s and 1990s, but rose to, respectively, 28 per cent and 32 per cent in 2006.

2. In the same period (between 1990 and 2004) the nominal value of global trade in services nearly tripled, increasing its share of global GDP from less than 8 percent to more than 10 percent. The UK has increased its exports of services in recent years, from 6 per cent of GDP in 1992 to 11 per cent in 2007.

   International capital flows also grew rapidly after 1992. Between 1997 and 2005, the U.S. current account deficit increased from -0.5 per cent of global GDP to -1.7 per cent. By 2008 the net foreign assets of Japan, emerging Asia and the oil exporting countries had risen to 12 per cent of world GDP, compared with less than 4 per cent in 1997.[2]

Although smaller in scale, the current account deficits of other "Anglosphere" economies were comparable in relative terms. With the exception of Canada's, the deficits of Australia, Ireland, New Zealand and the United Kingdom all increased between 1992 and 2007. At -4.2 per cent of GDP the UK's current account deficit was two and a half times larger than its average during the 1990s.[3]

3. Migration too increased (though not in Australia and New Zealand). In Britain international migrants increased from less than 7 per cent to 9 per cent of the population between 1990 and 2005. For the United States the increase was from 9 per cent to 13 per cent; for Ireland from 7 per cent to 14 per cent; for Canada from 16 per cent to 19 per cent – nearly a fifth of the population.[4]

These trends were not, of course, peculiar to the English-speaking world. In relative terms the growth of trade in goods mattered more in East Asia, the growth of trade in services more in South Asia, the current account deficits were even larger in some East European countries and the immigrant population shares bigger still in the states of the Persian Gulf. Globalization, as its name suggests, is ubiquitous, though it clearly affects some countries more than others. My contention here is that it had distinctive *political* implications for the Anglophone Right.

III

Unremarked by conservatives on both sides of the Atlantic – and, indeed, conservatives Down Under too – a new and much bigger trilemma was posing itself as a result of these great shifts. Suppose that a government can have any two of the following things, but not all three:

1. Globalization, as I have just defined it;

2. Social stability;

3. A small state.

Or, to put it differently, conservatives can have any two of the following things, but not all three:

1. Globalization;

2. Social stability;

3. Political power.

The problem can be elucidated as follows. Globalization, it turns out, gives rise to an over-optimized system which is highly efficient most of the time – because resources are optimally allocated through the effects of the division of labour and comparative advantage – but prone to crises: minor crises roughly every decade, major crises roughly every fifty years.[5]

The effect of globalization is therefore double-edged. Most of the time, aggregate economic volatility is reduced by international integration: that part of the "Great Moderation" story told by Ben Bernanke in 2004 holds good.[6] Measures of the volatility of GDP growth, hours worked, consumption, investment and productivity all tended to decline after 1984. However, recent events suggest that macroeconomic volatility was only in temporary abeyance.

For the individual citizen or firm, meanwhile, microeconomic volatility never went away. On the contrary, globalization seems to have increased it. This can be observed in the increased volatility of the profits, sales and employment of individual publicly traded companies. The earnings of the average worker have also become more volatile since the 1970s.[7] Globalization makes humanity as a whole richer, it seems, but it also makes the individual less secure. In the short run, we have to live with bigger and more frequent changes in employment and income; in the long run with the likelihood that we shall experience at least one really big global crisis.

What does this mean in practice? It appears to mean that if we want globalization we have to choose between either social stability or a small state of the sort that conservatives prefer. Why? Because the social disruption caused by globalization can be mitigated only by the kind of large-scale interventions that socialists and Keynesians devised during the last great financial crisis, that of the 1930s. Or so the Left would claim.

It is far from illogical that this crisis is perceived by many on the Left – not least the chief of staff of the most left-wing Democrat ever elected to be President of the United States – as an opportunity too "good" to be wasted. It is indeed a good opportunity to resuscitate the Marx and Engels's old idea of the nationalization of the banking system. It is an even better opportunity to resurrect the *General Theory* of John Maynard Keynes, with its claim that shortfalls in private consumption and investment can and should be compensated for by increases in government expenditure funded by borrowing.

The fact that the combination of an excessively large public sector and excessively large government deficits ultimately got the Western world into the stagflationary mess some of us remember in the 1970s – a mess that turned me into an undergraduate Thatcherite (or "punk Tory", as I liked to think) – is neither here nor there. As conservatives around the English-speaking world are discovering, in Australia and Canada as much as in Britain and America, the arguments that proved so effective in the Seventies and Eighties have lost their traction.

There was a time, let it not be forgotten, when the state did seem to be rolling back. Between 1982 and 1998, largely as a result of the policies of the Thatcher government, general government final consumption expenditure declined from 22.4 per cent to 18.2 per cent of GDP. Since then it has risen with depressing speed back to 22.3 per cent. A similar story can be told about public sector employment. From 1991 to 1998, it fell every year, with an overall reduction of 816,000.

From 1998, however, public sector employment rose with every passing year to reach a total of 5,846,000 in June 2005. That was 680,000 higher than in June 1998. Private sector employment rose by 1,241,000 in the same period. In other words, more than a third of new jobs created under New Labour in those seven years were in the public sector. Since that time, it is true, there have been attempts to reduce the public sector payroll, but these have been negated by renewed increases in 2008. The current total for public sector employment is 5,783,000 million.[8] We can expect that number to rise rapidly in the months ahead, even as private sector employment contracts.

The financial crisis not only provides governments of the Left with the perfect justification for increases in public sector expenditure and employment. It also allows them to throw fiscal caution to the wind, and engage in an international competition to see who can run the largest deficit. Currently the United States is in the lead, with a deficit that will exceed 12 per cent of GDP this year (a figure not seen since the Second World War), but the United Kingdom is not far behind. Add together all the government interventions inspired by this crisis – the capital injections, asset guarantees, fiscal stimuli and asset purchases – and the U.S. is already past 50 per cent of GDP; the UK is in second place on around 45 per cent.

These are daunting figures. They imply massive increases in government debt over the next five to ten years. According to the White House's budget proposals, the U.S. federal debt will rise from $10 trillion to $23 trillion by 2019, from 70 to 100 per cent of GDP – and that is on the highly optimistic assumption that there will a return to 3 per cent growth next year and 4 per cent thereafter. A comparable debt explosion seems likely in the UK. This is hyper-Keynesianism.

Recognizing a kindred spirit, Gordon Brown has joined President Obama in exhorting the rest of the world to adopt the same policy of fiscal stimulus at all costs. In his address to both Houses of Congress earlier this month, he called for "a scale of stimulus round the world equal to the depth of the recession and the dimensions of the recovery we must make".[9]

Conservatives simply do not know how to react to all this. Should they decry the irresponsibility of such large deficits, as a growing number of Republicans are inclined to (hypocritically, given the fiscal profligacy of George W. Bush's administration and, indeed, of Congress when it was under Republican control)?

Should conservatives remain committed to tax cuts? Hard to do at the same time as they criticize excessive deficits – and especially hard to sustain when the Keynesians retort that the income multiplier is bigger than the tax multiplier and that public job creation is therefore preferable to tax reduction as a source of stimulus. On both sides of the Atlantic conservatives are losing these arguments. Ken Clarke's recent *faux pas* on the abolition of inheritance tax on estates worth less than £1 million is a case in point. Is it a Conservative "aspiration"? A "commitment"? Or is it perhaps an irrelevance?

To be haggling over inheritance tax in the midst of the greatest financial crisis since the 1930s is to appear to be rearranging the deckchairs on the *Titanic*. Committed to both globalization and the idea of the small state, conservatives end up being identified with all the negative social consequences of free trade, capital flows and migration, particularly the job losses associated with outsourcing, off-shoring and immigration, not to mention the financial crisis. Only the Left can offer what seems to be a credible response: globalization plus social stability provided by a strong interventionist state.

IV

It is true that the incompetence of the Brown government's handling of the financial crisis has given rise to the reverse of the situation I described in 1992. Today – and I believe this has been true since the run on Northern Rock in September 2007 and its nationalization five months later – Gordon Brown's reputation for economic prudence is in tatters. He, like Major after September 1992, is politically a dead man walking. If he contests the next election, he will surely lose.

Yet for David Cameron to become Prime Minister because New Labour has self-destructed would be the occasion for no more than two cheers (cheers, too, can pose a trilemma). If the Conservatives come to power without having worked out which parts of my unholy trinity they actually want, they will not last long in office.

Is there any way for them to do this without abandoning either their commitment to the free market, their commitment to social order or their commitment to the small state? I believe there is, but it will require them to redefine each of these things. They need to recognize:

a) not only the inherent vulnerability of the liberalized global economy, but also the continuing distortions imposed on the world market by governments, which have served to increase that vulnerability;

b) the degree to which social stability should not in fact be sacrosanct to conservatives, who should be prepared to embrace social change on what might be called the "Leopard" principle, after the aphorism in Lampedusa's great novel *Il Gattopardo*: "If we want things to remain as they are, things have to change";

c) the possibility that a new kind of small but "smart" state could more effectively regulate the interaction of globalization and social change than the post-war model of big government, with its twin obsessions of economic planning and demand management.

The first part of the conservative solution to the trilemma is to reaffirm our faith in Adam Smith's vision of the wealth of nations enhanced by free exchange by pointing out how many government distortions still impede the working of globalization. Let us not lose sight of the persistence of tariffs, subsidies and other barriers to free trade in agricultural products, for example. Let us remind people that China is not a paragon of free market virtue, but still at its core a planned economy which imposes capital controls to prevent its citizens from investing abroad and accumulates excessive international reserves by suppressing the natural appreciation of its currency.

The second part of my solution is for us to learn to stop worrying and love social change. No one wants social instability, to be sure, but nor do we want social stasis. The key here is to distinguish between an orderly society, in which crime and other forms of disorder are kept to a minimum, and a rigid society, in which order is achieved at the expense of social mobility. The fundamental difference between conservatives and their opponents should not be (as the latter would have it) that conservatives favour inequality, while they favour equality. The difference is that conservatives favour social mobility, and believe that some measures adopted to promote equality – particularly large-scale redistributive transfers from upper to lower income groups – may have the unintended consequence of reducing mobility.

The third part of my solution to the trilemma is to reflect more deeply on how we think the state should work. One of the more troubling features of British Conservatism in recent years has been the tendency of the party's leaders to allow the Labour government to seize and retain the moral high ground on the issue of public spending and, to a degree, on taxation too. I do not mean to criticize David Cameron or George Osborne, both of whom I greatly admire and respect. I simply think there has been a failure on the part of conservative intellectuals to arm them with effective arguments against the New Labour mantra that Conservatism is equivalent to "cuts" in public services.

Rather than get sucked into an argument about public finance the terms of which are defined by hyper-Keynesians, we need to counter with a new and more credible vision of the state's role in times of volatility.

I would make two points. The first is that monetarism is not dead but alive and well, at least at the Federal Reserve. If the Fed's mistakes under Alan Greenspan were to blame for the twin bubbles on the stock market and the property market, under his successor Ben Bernanke there has been a sincere effort to learn the right lessons from the Great Depression. The playbook at the Fed has not been Keynes's *General Theory* but Milton Friedman and Anna Schwartz's *Monetary History of the United States*. Future historians will have a job on their hands to work out which was more effective in countering the financial crisis of 2007-9: the huge fiscal deficits I have already described or the massive expansion of the Federal Reserve's balance sheet through a succession of targeted "loan facilities". My sense is that the Fed's response has been the more important one, though (as John Taylor has recently argued) it may prove to have been excessive.

The second point is that the state's role should be not to provide people with substitute jobs in a bloated public sector funded with money borrowed from the next generation, but to prepare them, primarily through improved education, to be more economically flexible. The state needs to be a "smart" helpmeet to the market, not a substitute for it. It needs to pre-empt crises rather than just react to them.

Ironically, the most original response to the challenge of globalization's microeconomic volatility has come, not from Anglophone conservatives, but from Scandinavian Social Democrats. The term "flexicurity" was coined in the 1990s by the Danish Prime Minister Poul Nyrup Rasmussen. The key idea was that Danes should get used to the new volatility of employment by acquiring skills to make them more flexible as well as more productive. As a result of radical labour market reforms that abolished the minimum wage and replaced the dole with "activation" programmes for the unemployed, Denmark has acquired one of the most adaptable labour forces in Europe. Around one in every four Danish workers changes job each year. What is more, the Danes seem to like this: 70 per cent of Danes think it is "good for people to change jobs every few years".

The catch, of course, is that Denmark is anything but a small state. Total tax revenue represents 49 per cent of GDP, the highest figure in Organization for Economic Cooperation and Development. Income tax rates range upwards from 42 to 68 per cent. Redistribution through the fiscal system has made Denmark one of the most equal societies on earth. And nearly all the jobs created in Denmark since 1990 have been in the public sector.[10] This is hardly a model conservatives would wish to emulate.

The key question is whether there is nevertheless a kernel of truth in the idea of flexicurity that conservatives could purloin and genetically engineer to form the basis of a new model of the classical liberal state. To my mind there is much to be said for a policy that aims to improved secondary and tertiary education in this country so as to widen the range of skills of the average school-leaver.

There is no reason, moreover, why this effort should come exclusively from the public sector. On the contrary: the most successful institutions in the United Kingdom today are its private schools, as a glance at the *Financial Times* Top 1000 list on Saturday made clear. Their success is strongly reminiscent of the success of private universities like the one that employs me in the United States. Precisely their financial independence has been the key to the maintenance of their educational standards. Whenever British Conservatives feel disheartened, they should turn back to the independent schools. It is no accident that they are the institutions that work best in this country.

V

The governments of the Left on both sides of the Atlantic are currently presiding over explosive increases in public expenditure, public debt and public employment, the short-run benefits of which they almost certainly overestimate, and the medium-term costs of which they almost certainly underestimate. Yet conservatives have no articulate response. It is high time they found one, and removed themselves from the horns of the trilemma.

In my view there is a way to do this. I return to my original example of the woman who wants to have it all. You were probably thinking when I made that point that you know at least one woman who *has* succeeded in having it all: a brilliant career, children and a happy marriage. In horse-racing parlance this is known as the "trifecta" (technically, a successful bet on which horses will come first, second and third in a race). The Tory trifecta in my view would go like this:

1. Reaffirmation of our commitment to the principles of free trade that underpin today's global economy;

2. Adoption of a public-private educational system of "flexicurity" designed to equip our citizens for the more volatile and mobile society of the twenty-first century;

3. Reinvigorated criticism of the hyper-Keynesian remedies to the crisis currently being implemented by the governments of the Left.

The trilemma of globalization, social order and the size of the state is not a new one. In the nineteenth century – which was in many ways the first age of globalization – it pitted the Peelites against the romantic Tories; the readers of David Ricardo against the readers of Thomas Carlyle. In more recent times it was the key to understanding the difference between "Wets" and "Dries". Today it is responsible not so much for division as for confusion.

I hope I have done at least something tonight to clear that confusion up and offer a Tory trifecta in answer to the troublesome trilemma.

NOTES

[1] World Bank, *World Development Indicators 2006*: http://devdata.worldbank.org/wdi2006/contents/Section6_1.htm.

[2] International Monetary Fund, *World Economic Outlook* (2008), Figure 1.14.

[33] World Bank, WDI Online.

[4] Ibid.

[5] See Nassim Nicholas Taleb, "The Fourth Quadrant: A Map of the Limits of Statistics", *Edge*, September 15, 2008.

[6] Ben Bernanke, "Remarks at the meetings of the Eastern Economic Association, Washington, DC", February 20, 2004.

[7] Diego Comin, "The Great Moderation", Harvard Business School Case N9-709-023, January 6, 2009. Comin measures volatility as the standard deviation of the ten annual observations centred on a particular year. He attributes the moderation of aggregate volatility and the increase of microeconomic volatility to the increasingly rapid diffusion of technology, but this clearly cannot be separated from the reduction in barriers to trade, investment and migration associated with globalization. The technologies that have spread fastest to U.S. households in recent years – the personal computer, the mobile phone, the Internet and the DVD player – have done so in large measure because Asian imports have driven down their prices.

[8] Data from http://www.statistics.gov.uk/.

[9] Gordon Brown, "Address to both Houses of Congress", March 4, 2009.

[10] Arthur A. Daemmrich, "Denmark: Globalization and the Welfare State", Harvard Business School Case N2-709-015, March 4, 2009.