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On the cusp of economic history

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DAVOS, Switzerland: Is economic history about to change course? Among the chieftains of politics and industry gathering in Davos for the World Economic Forum on Wednesday, a consensus appears to be building that the capitalist system is in for one of those rare and tempestuous mutations that give rise to a new set of economic policies.

As the prospect of a U.S. recession overshadows a tense and drawn-out election campaign in the world's most emblematic market economy, a corrosive cocktail of factors is eating away at old certainties: Power is steadily leaking from West to East. Income inequalities are rising in rich countries.

And signs of a protectionist backlash are multiplying as worries about climate change, the rise of state-run investment funds and the bursting of the recent credit bubble give novel ammunition to those in the West who question free markets and clamor for more shelter from globalization.

What exactly will emerge when the dust settles is hard to predict, economists and executives say. But this much seems clear: With the frontier between state and market once again up for grabs, the era of easy globalization is over - and big government in one form or another is back.

"The pendulum between market and state is swinging back," Pascal Lamy, director general of the World Trade Organization, said by telephone before traveling to Davos. "The year 2008 is a crucial year that could end up setting the tone for some time to come. What we need is an ideological mutation without falling into the trap of protectionism."

One such mutation in mainstream economic policy took place after the Depression of 1929, which led to a protectionist interlude and then gave rise to Keynesian demand-side policies and eventually the welfare state. Another took place following the oil price shocks in the 1970s, which refocused policy makers' attention to supply-side measures and strengthened those pushing for privatization and free markets as the best way to stimulate growth.

When students of economics open their history books in 2030, they might read about 2008 as the year when the groundwork was laid for a re-regulation of certain markets, a more redistributive tax system and new forms of international policy coordination, economists say.

"We are seeing the seeds of a new paradigm," said Kenneth Rogoff, a professor at Harvard University and former chief economist of the International Monetary Fund, who will be at Davos this year. "Whoever wins the U.S. election will have to pay more attention to equity. And whatever comes out of the next climate change agreement will be international economic cooperation on a scale never seen before."

According to Stephen Roach, chief economist for Asia at Morgan Stanley, who will also be among the 2,400 participants in Davos to ponder what forum organizers have labeled "The Power of Collaborative Innovation," some basic notions guiding economic thinking in recent decades have been challenged by ever-faster globalization.

In theory, Roach said, wages increase with productivity growth and all economies have a comparative advantage in the production of something. But real wage stagnation in some of the richest economies and increasing fears that China and India combined will eventually be able to make just about everything the West can, only cheaper, were turning that theory on its head, he said.

Weekly earnings for full-time American workers in the second quarter last year were unchanged from their 2000 levels - even though productivity grew by 18 percent in the same period.

Fifty-four percent of Western Europeans and 43 percent of Americans now believe their children will be worse off than they are in economic terms, according to a Gallup International poll in the last quarter of 2007 across 60 countries.

"Economic theory tells us that globalization is a win-win, but it isn't, at least not in the West," Roach said. "The theory was written for another era. We have to ask some hard questions about unfettered capitalism. We need a new script."

The risk is that Western governments, mindful of the growing backlash among voters, will be tempted to rewrite the script by engaging in old and new forms of protectionism.

Roach counted more than 20 anti-China bills in the U.S. Congress last year. In 2006, when the number of such initiatives was already high, it never resulted in action, he said. But with presidential candidates from both parties vowing to take a tough stance on China, there is a greater than 60 percent chance, Roach predicted, that some of the pending bills will become law in coming months with bipartisan majorities big enough to avoid a presidential veto.

And suddenly there are a lot of broadly acceptable concerns that can help disguise protectionist tendencies.

The most prominent one is the environment. Since climate change was catapulted onto the global agenda, European and American officials have looked into ways of making importers - like China and India - pay, since they do not adhere to the same greenhouse emission standards.

Another concern is financial markets. The credit bubble associated with U.S. subprime loans was the latest in a series of asset bubbles, from equities to housing, to burst in recent years and has further shaken confidence in markets.

There has also been an outcry against state-run investment funds from places like China, Kuwait and soon Russia buying stakes in Western companies. The noise has subsided somewhat as American banks, squeezed by the subprime crisis, are in desperate need of capital.

But as these so-called sovereign wealth funds grow, and the shift in savings from West to East and from private to public sector accelerates, complaints are bound to flare anew, said Daniel Yergin, chairman of Cambridge Energy Research Associates in Boston and the author of "Commanding Heights," a history of the world economy.

"This is new, it's big and it's only going to get bigger," Yergin said. "People are really going to struggle with the issue of capital flows. The question is: will there be international norms and rules or is the focus going to be on protection?"

The same question could be asked about the growing number of takeovers of Western companies by a new breed of cash-rich and technology-hungry multinationals from emerging economies. By 2006, the slice of cross-border mergers and acquisitions from emerging economies had reached a record 14 percent. Companies like Mittal Steel of India and Lenovo of China spent $123 billion in more than 1,000 deals, according to the United Nations Conference on Trade and Development. K.V. Kamath, chief executive of ICICI Bank of India, recalled a workshop he attended three years ago in Davos, at which participants unanimously agreed that despite globalization, no non-Western banks would crack the ranks of the world's largest banks by market capitalization anytime soon. Today, 3 Chinese banks are in the top 10. "I didn't see it coming either, but the same thing will happen in other sectors," Kamath said. His bank, the biggest private bank in India, calculates that Chinese and Indian companies on average double in size every three years. "Investment is increasingly flowing from east to west," he said.

So far there has been more talk of protectionism than action, but that could change, said Lamy, the WTO chief. This year might prove crucial for finalizing the Doha trade round, stalemated by sparring over agricultural subsidies in the developed world, and tariffs and market access in developing countries. "It is perhaps the last chance we have," Lamy said.

Part of the battle has to be fought at home, where Western governments are feeling the need to address the growing malaise voters feel toward globalization. More equitable tax systems are one response; Rogoff, the Harvard professor, argues that a flat rate tax in the United States would be less regressive than the current system. Others say an even deeper review might be called for. Nicolas Sarkozy, the French president, this month commissioned two Nobel economists, Amartya Sen and Joseph Stiglitz, to help devise a more holistic indicator of economic progress than growth in gross domestic product, which fails to account for issues like income inequality that have been at the heart of the globalization debate.

"Economics is not just politics," Sen said. "There is more to human progress than aggregate statistics of growth. We have to ask the right questions and concentrate on what matters to people."

These ideas are becoming more mainstream. I hope through French initiative they will become more widely accepted in Europe and beyond."

A year and a half ago, researchers at Yergin's group drew up a number of scenarios for the world economy in 2030. One of them, "Asian Phoenix," saw a world in which protectionism was kept at bay and Asian economies kept underpinning swift global growth. The other, "Global Fissure," was a troubled world economy with widespread economic nationalism and a backlash against globalization.

At the time, the latter scenario seemed to be the more remote. But that may be changing, Yergin said. "What seemed highly unlikely," he said, "could become rather more likely."