file global economy

The Atlantic Monthly

THE ECONOMY

Toward a Global Open Society

A billionaire financier, wrongly accused of being a hypocritical capitalist for his February* Atlantic *cover story, "The Capitalist Threat," returns to the fray

by George Soros

Discuss this article in the Global Views forum of Post & Riposte.

From the archives:

□ **"The Capitalist Threat," by George Soros (May, 1995)**
"What kind of society do we want? 'Let the free market decide!' is the often-heard response. That response, a prominent capitalist argues, undermines the very values on which open and democratic societies depend."

LET me start with the obvious. We do live in a global economy. But it is important to be clear about what we mean by that. A global economy is characterized not only by the free movement of goods and services but, more important, by the free movement of ideas and of capital. This applies to direct investments and to financial transactions. Though both have been gaining in importance since the end of the Second World War, the globalization of financial markets in particular has accelerated in recent years to the point where movements in exchange rates, interest rates, and stock prices in various countries are intimately interconnected. In this respect the character of the financial markets has changed out of all recognition during the forty years that I have been involved in them. So the global economy should really be thought of as the global capitalist system.

Global integration has brought tremendous benefits: the benefits of the international division of labor, which are so clearly proved by the theory of comparative advantage; dynamic benefits such as economies of scale and the rapid spread of innovations from one country to another, which are less easy to demonstrate by static equilibrium theory; and such equally important noneconomic benefits as the freedom of choice associated with the international movement of goods, capital, and people, and the freedom of thought associated with the international movement of ideas.

But global capitalism is not without its problems, and we need to understand these better if we want the system to survive. By focusing on the problems I'm not trying to belittle the benefits that globalization has brought, as some readers of my previous *Atlantic* article assumed. The benefits of the present global capitalist system, I believe, can be sustained only by deliberate and persistent efforts to correct and contain the system's deficiencies. That is where I am at loggerheads with laissez-faire ideology, which contends that free markets are self-sustaining and market excesses will correct themselves, provided that governments or regulators don't interfere with the self-correcting mechanism.

Let me group the deficiencies of the global capitalist system under five main headings: the uneven distribution of benefits, the instability of the financial system, the incipient threat of global monopolies and oligopolies, the ambiguous role of the state, and the question of values and social cohesion. The categories are of course somewhat arbitrary, and the various problem areas are interconnected.

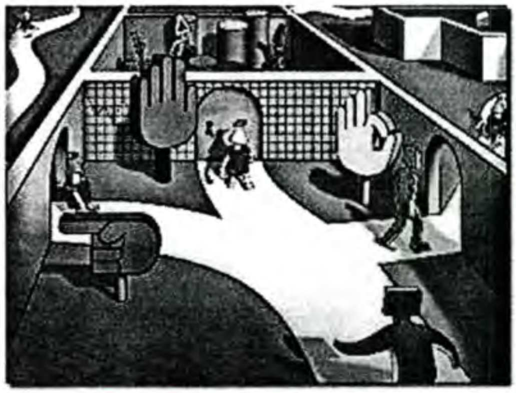
1. The benefits of global capitalism are unevenly distributed. Generally speaking, capital is in a much better position than labor, because capital is more mobile. Moreover, financial capital is better situated in the global system than industrial capital; once a plant has been built, moving it is difficult. To be sure, multinational corporations enjoy flexibility in transfer pricing and can exert pressure at the time they make investment decisions, but their flexibility doesn't compare to the freedom of choice enjoyed by international portfolio investors. There is also an advantage in being at the center of the global economy rather than at the periphery. All these factors combine to attract capital to the financial center and account for the ever increasing size and importance of financial markets.

2. Financial markets are inherently unstable, and international financial markets are especially so. International capital movements are notorious for their boom-bust pattern. During a boom capital flows from the center to the periphery, but when confidence is shaken it has a tendency to return to its source. I have seen many ebbs and flows and booms and busts, and though I fully recognize that international capital markets have become much more institutional in character and demonstrate much greater resilience, I cannot believe that the present boom will not be followed by a bust until history proves me wrong.

The risk of a breakdown is greatly increased by the fact that our theoretical understanding of how financial markets operate is fundamentally flawed. Economic theory has been built on the misleading concept of equilibrium. In my view, equilibrium is elusive because market participants are trying to discount a future that is itself shaped by market expectations. For instance, a company whose stock is overvalued can use that to justify the inflated expectations of its shareholders, but only up to a point. This renders the outcome indeterminate, and it is only by accident that the actual course of events corresponds to prevailing expectations. Market participants, if they are rational, will recognize that they are shooting at a moving target rather than discounting a future equilibrium. The theory of rational expectations makes the heroic assumption that market participants as a group are in a position to discount the future accurately. That assumption may yield a hypothetical equilibrium, but it has little relevance to actual market behavior -- and neither market operators nor regulators have ever fully accepted the theory, exactly because they are rational people. I am told that economic theory has gone a long way toward recognizing and studying disequilibrium situations. Nevertheless, the laissez-faire idea that markets should be left to their own devices remains very influential. I consider it a dangerous idea. The instability of financial markets can cause serious economic and social dislocations.

The question poses itself: What should be done to preserve the stability of the financial system? This cannot be answered in the abstract, because every situation is different. Financial markets are best understood as a historical process, and history never quite repeats itself. The recent turmoil in Asian markets raises difficult questions about currency pegs, asset bubbles, inadequate banking supervision, and the lack of financial information which cannot be ignored. Markets cannot be left to correct their own mistakes, because they are likely to overreact and to behave in an indiscriminate fashion.

3. Instability is not confined to the financial system, however. The goal of competitors is to prevail, not to preserve competition in the market. The natural tendency for monopolies and oligopolies to arise needs to be constrained by regulations. The process of globalization is too recent for this to have become a serious issue on a global level, but since we are dealing with a historical process, in time it will.



4. But whose job is it to prevent undue concentration of power and to preserve stability in financial markets? This brings me to the role of the state. Since the end of the Second World War the state has played an increasing role in maintaining economic stability, striving to ensure equality of opportunity, and providing a social safety net, particularly in the highly industrialized countries of Europe and North America. But the capacity of the state to look after the welfare of its citizens has been severely impaired by the globalization of the capitalist system, which allows capital to escape taxation much more easily than labor can. Capital will tend to avoid countries where employment is heavily taxed or heavily protected, leading to a rise in unemployment. That is what has happened in continental Europe. I am not defending the antiquated European social-security systems, which are badly in need of reform; but I am expressing concern about the reduction in social provisions both in Europe and in America.

This is a relatively new phenomenon, and it has not yet had its full effect. Until recently the state's share of GNP in the industrialized countries taken as a group was increasing; it had almost doubled since the end of the Second World War. Although the ratio peaked in the 1980s, it has not declined perceptibly. The Thatcher and Reagan governments embarked on a program of reducing the state's role in the economy. What has happened instead is that the taxes on capital have come down while the taxes on labor have kept increasing. As the international economist Dani Rodrik has argued, globalization increases the demands on the state to provide social insurance while reducing its ability to do so. This carries the seeds of social conflict. If social services are cut too far while instability is on the rise, popular resentment could lead to a new wave of protectionism both in the United States and in Europe, especially if (or when) the current boom is followed by a bust of some severity. This could lead to a breakdown in the global capitalist system, just as it did in the 1930s. With the influence of the state declining, there is a greater need for international cooperation. But such cooperation is contrary to the prevailing ideas of laissez-faire on the one hand and nationalism and fundamentalism on the other.

From the archives:

□ **"How the World Works," by James**

The state has played another role in economic development: in countries deficient in local capital it has allied itself with local business interests and helped them to accumulate capital. This strategy has proved successful

Fallows (December, 1993)
"Americans persist in thinking that Adam Smith's rules for free trade are the only legitimate ones. But today's fastest-growing economies are using a very different set of rules. Once, we knew them -- knew them so well that we played by them, and won. Now we seem to have forgotten."

□ **"Was Democracy Just a Moment?" by Robert D. Kaplan (December, 1997)**
"The global triumph of democracy was to be the glorious climax of the American Century. But democracy may not be the system that will best serve the world -- or even the one that will prevail in places that now consider themselves bastions of freedom."

□ **"Jihad vs. McWorld," by Benjamin Barber (March, 1992)**
"The two axial principles of our age -- tribalism and globalism -- clash at every point except one: they may both be threatening to democracy."

to accumulate capital. This strategy has proved successful in Japan, Korea, and the now wounded tigers of Southeast Asia. Although the model has worked, it raises some important questions about the relationship between capitalism and democracy. Clearly, an autocratic regime is more favorable to the rapid accumulation of capital than a democratic one, and a prosperous country is more favorable to the development of democratic institutions than a destitute one. So it is reasonable to envisage a pattern of development that goes from autocracy and capital accumulation to prosperity and democracy. But the transition from autocracy to democracy is far from assured: those who are in positions of power cling tenaciously to their power.

Autocratic regimes weaken themselves by restricting free speech and allowing corruption to spread. Eventually they may collapse of their own weight. The moment of truth comes when they fail to sustain prosperity. Unfortunately, economic dislocation and decline do not provide a good environment for the development of democratic institutions. So the political prospects for the Asian economic miracle remain cloudy at best.

5. This brings me to the most nebulous problem area, the question of values and social cohesion. Every society needs some shared values to hold it together. Market values on their own cannot serve that purpose, because they reflect only what one market participant is willing to pay another in a free exchange. Markets reduce everything, including human beings (labor) and nature (land), to commodities. We can have a market economy but we cannot have a market society. In addition to markets, society needs institutions to serve such social goals as political freedom and social justice. There are such institutions in individual countries, but not in the global society. The development of a global society has lagged behind the growth of a global economy. Unless the gap is closed, the global capitalist system will not survive. When I speak of a global society, I do not mean a global state. States are notoriously imperfect even at the national level. We need to find new solutions for a novel situation, although this is not the first time that a global capitalist system has come into being. Similar conditions prevailed at the turn of the century. Then the global capitalist system was held together by the imperial powers. Eventually, it was destroyed by a conflict between those powers. But the days of the empires are gone. For the current global capitalist system to survive, it must satisfy the needs and aspirations of its participants.

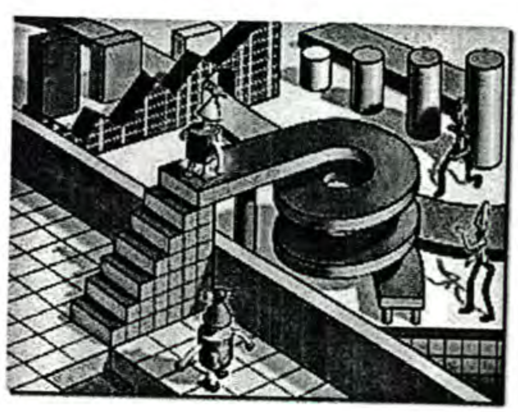
Our global society contains many different customs, traditions, and religions; where can it find the shared values that would hold it together? I should like to put forward the idea of what I call the open society as a universal principle that recognizes the diversity inherent in our global society, yet provides a conceptual basis for establishing the institutions we need. I realize that gaining acceptance for a universal principle is a tall order, but I cannot see how we can do without it.

WHAT is the open society? Superficially, it is a way to describe the positive aspects of democracy: the greatest degree of freedom compatible with social justice. It is characterized by the rule of law; respect for human rights, minorities, and minority opinions; the division of power; and a market economy. The principles of the open society are admirably put forth in the Declaration of Independence. But the Declaration states, "We hold these truths to be self-evident," whereas the principles of the open society are anything but self-evident; they need to be established by convincing arguments.

There is a strong epistemological argument, elaborated by Karl Popper, in favor of the open society: Our understanding is inherently imperfect; the ultimate truth, the perfect design for society, is beyond our reach. We must therefore content ourselves with the next best thing -- a form of social organization that falls short of perfection but holds itself open to improvement. That is the concept of the open society: a society open to improvement. The more conditions are changing -- and a global economy fosters change -- the more important the concept becomes.

But the idea of the open society is not widely accepted. On the contrary: the epistemological argument has not even been properly considered, and the idea of a global open society is often explicitly rejected. There are those, for instance, who argue that values are different in Asia. Of course they are different. The global society is characterized by diversity. But fallibility is a universal human condition; once we acknowledge it, we have found a common ground for the open society, which celebrates this diversity.

Recognition of our fallibility is necessary but not sufficient to establish the concept of the open society. We must combine it with some degree of altruism, some concern for our fellow human beings based on the principle of reciprocity.



Any variety of Asian, or other, values would fit into a global open society, provided that some universal values reflecting our fallibility and our concern for others -- such as the freedom of expression and promises contained in the preamble of its charter. Moreover, there is no consensus on the need for better international institutions.

From the archives:

□ **Flashback: "Nations of the World, Unite!" (August, 1997)**
The League of Nations fell victim to America's aloofness. Does the United Nations face the same fate?

□ **Flashback: "Cold War, Part II?" (February, 1997)**
How did NATO come into being? Why does it persist to this day? Should it persist? *Atlantic* articles discuss the history and possible future of NATO.

□ **"Changing the World on a Shoestring," by David Bornstein (January, 1998)**
"An ambitious foundation promotes social change by finding 'social entrepreneurs' -- people who have new ideas and the knack for implementing them."

What is to be done? We need to establish certain standards of behavior to contain corruption, enforce fair labor practices, and protect human rights. We have hardly begun to consider how to go about it.

As regards security and peace, the liberal democracies of the world ought to take the lead and forge a global network of alliances that could work with or without the United Nations. NATO is a case in point. The primary purpose of these alliances would be to preserve peace; but crisis prevention cannot start early enough. What goes on inside states is of consequence to their neighbors and to the world at large. The promotion of freedom and democracy in and around these alliances ought to become an important policy objective. For instance, a democratic and prosperous Russia would make a greater contribution to peace in the region than would any amount of military spending by NATO. Interfering in other countries' internal affairs is fraught with difficulties -- but not interfering can be even more dangerous.

Right now the global capitalist system is vigorously expanding in both scope and intensity. It exerts a tremendous attraction through the benefits it offers and, at the same time, it imposes tremendous penalties on those countries that try to withdraw from it. These conditions will not prevail indefinitely, but while they do, they offer a wonderful opportunity to lay the groundwork for a global open society.

With the passage of time the deficiencies are likely to make their effect felt, and the boom is likely to turn into a bust. But the ever-looming breakdown can be avoided if we recognize the flaws in time. What is imperfect can be improved. For the global capitalist system to survive, it needs a society that is constantly striving to correct its deficiencies: a global open society.

George Soros is an investor and a philanthropist, and the chairman of the Open Society Institute, an international charitable foundation based in New York. His article "The Capitalist Threat" was *The Atlantic*'s cover story last February.

Illustrations by Barton Stabler

The Atlantic Monthly; *January 1998; Toward a Global OPen Society; Volume 281, No. 1; pages 20 - 32.*