CHAPTER 7

The Principles of Embedded Liberalism: Social Legitimacy and Global Capitalism

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In this essay we revisit the principles of "embedded liberalism" and argue for their relevance to the contemporary global economy. The most essential principle is the need for markets to enjoy social legitimacy, because their political sustainability ultimately depends on it. From this principle we analyze three current sets of practices and institutions in which ongoing crises of legitimacy demonstrate the need for a renewal of embedded liberalism and a revitalization of global governance. They are: the activities of transnational corporations, particularly with regard to core standards in labor and human rights; the organization of the international financial architecture; and the formal rules and informal norms of international organizations.

Learning the Lessons of Embedded Liberalism

The post-1945 world economy embodied a social bargain. In the aftermath of the political and economic chaos of 1920s, the Great Depression of the 1930s, and the Second World War—all of which together shattered the world order within the span of a single generation—policymakers sought to reorganize and rebuild the world economy by restoring open markets, promising to mitigate their adverse social consequences and thereby preempting societal demands, from both left and right, to replace markets altogether. The failure to strike such a compromise earlier had undermined international cooperation in trade and macroeconomic policy during the 1920s and 1930s, just as it had caused the collapse of the first era of globalization, circa 1870 to 1914.

Influential scholars and policymakers began to make sense of how that first era of globalization had lost its way. In his 1944 book, *The Great Transformation*, Karl Polanyi distinguished "embedded" from "disembedded" economic orders. On Polanyi's reading of history, economic orders had always reflected the principles and values of the societies in which they were situated. Only in the middle

of the nineteenth century was the idea of an economy that was somehow separate from society, a collection of markets with its own inexorable principles and logic, invented and then cultivated. This idea, which informed classical liberalism, was not only new but revolutionary. Whereas previous economic orders had always been "embedded" in social and political relations, this new liberalism succeeded in "disembedding" first national markets and, soon thereafter, cross-border markets, and ultimately global markets as well. Several policy practices were essential to this process of disembedding markets, above all the free movement of goods, services, and capital among nations.

The outbreak of war in 1914 led the combatant governments to suspend the convertibility of their currencies into gold and, often, into other currencies also. Fixed exchange rates, international commerce, and cross-border investment collapsed. In the early 1920s, European governments sought in vain to reestablish on the old principles of classical liberalism the prewar system in political circumstances that were much changed. Europe's continental empires had disintegrated into successor states whose governments often carefully guarded their economic autonomy. The working classes, long disenfranchised, empowered the left and politicized macroeconomic policymaking for the first time. Factories had been destroyed, public finances ruined, and currencies debauched throughout the continent. Germany struggled to make a success of the Weimar Republic's fragile democracy, but soon veered to the far right. The United States declined the opportunity of world leadership and withdrew instead into isolation. Russia was preoccupied by its Bolshevik Revolution, and Japan soon turned to militarism.

When U.S. and European policymakers, among them the great British economist John Maynard Keynes, began to debate the rules by which the international economy ought to be reconstructed, they agreed with the basic insight articulated by Polanyi: the disembedding of markets had been politically unsustainable. Simply put, national societies rejected laissez-faire; across widely varying political spectra, the first era of globalization had come to be seen as illegitimate by all segments of society, save possibly the bankers. Thus this most important lesson was drawn: markets that societies do not recognize as legitimate cannot last. So, policymakers set out to make sure that, this time around, cross-border markets would be more acceptable to the people who worked (and lived) within them and voted for the politicians who would regulate them. Markets would be reconciled with the values of social community and domestic welfare.

The formulation in a 1982 article by one of the authors of the present essay, John G. Ruggie, has become the dominant interpretation of the postwar international economy: a reconciliation of market and society termed *the compromise*

of embedded liberalism. "Unlike the economic nationalism of the thirties, it would be multilateral in character; unlike the liberalism of the gold standard and free trade, its multilateralism would be predicated upon domestic interventionism." The practices of domestic interventionism would tame the socially disruptive effects of markets without, however, eliminating the welfare and efficiency gains derived from cross-country trade. National societies shared the risks through varieties of safeguards and insurance schemes that composed, in part, the European welfare states or, in the ever-exceptional United States, the New Deal state. Sophisticated modeling has demonstrated that embedded liberalism generated both better long-term economic performance and social protection than its laissez-faire predecessor.

In that same article, Ruggie conjectures that "the resurgent ethos of liberal capitalism"—what later became known as neoliberalism—threatened to undo the compromise of embedded liberalism as the world had known it. In the event, it wasn't merely embedded liberalism's specific policy tools that became discredited; its paradigm of political economy was itself attacked and undermined. An analysis of the specifics of this shift in thought is not essential to our learning the lessons of the era of embedded liberalism, circa 1945 to 1985. What is important is recognizing that our current era of globalization and its neoliberal paradigm have reached the point themselves of suffering from a profound crisis of legitimacy. If that crisis is not resolved by deft policymaking in the United States and around the world, globalization is likely to be undone by national policy reactions driven by societies that have grown increasingly skeptical of newly disembedded global markets. Policymakers must recognize, moreover, that this crisis of legitimacy for globalization has been unfolding since the end of the 1990s. The crash of 2008 did not cause this crisis, but has surely made it worse.

We therefore propose that policymakers revisit the principles of embedded liberalism in the hopes of embedding, and thereby legitimating, the practices of transnational corporations, the governance of financial markets, and the rules of international organizations. The core principle of embedded liberalism is the need to legitimize international markets by reconciling them to social values and shared institutional practices. This principle implies the need to bridge gaps in the governance of firms that produce, buy, and sell around the world, firms whose rights have in effect in the recent era of globalization outstripped the global frameworks that should regulate them. This principle further implies the need to balance, both domestically and internationally, the benefits of internationalized financial markets with their substantial risks; to share the rewards and costs of the disruptions created by internationalized markets across national

societies; and to ensure that global governance is based on multilateral deliberation among countries whose leaders believe that the influence of their voices reflects their place in a multipolar—or at least "nonpolar"—world.

Embedding the Activities of Transnational Corporations

The most visible institutional expression of globalization today is the transnational corporation (TNC). TNCs number approximately 77,000, with 800,000 subsidiaries and millions of suppliers. Critics in the industrialized countries blame TNCs for exporting jobs to poorer countries with lower labor costs and weaker protective regimes for labor, and for driving down the wages of workers whose jobs are not exported. In the developing world, TNCs are frequently seen as engaging in social and environmental practices they could never get away with back home, because they are too powerful for capital-poor governments to challenge. While containing elements of truth, both views are stereotypes. Of course, even flawed perceptions can drive policy—in the case of TNCs typically in a populist/economic nationalist direction.

Yet the fundamental challenge for the social legitimacy of TNCs is rooted not in these shifting perceptions, but in an underlying institutional reality. While the legal rights enabling TNCs to operate globally have expanded significantly over the past generation, their activities are not adequately encompassed by global regulatory frameworks. This results in growing governance gaps—between the scope and impact of their activities, and the capacity of societies to manage their adverse consequences.

The more than 2,500 bilateral investment treaties currently in effect are a case in point, the vast majority of which were adopted in the 1990s. While providing legitimate protection to foreign investors, these treaties also permit those investors to take host states to binding international arbitration, not only for expropriation but also for a variety of alleged damages resulting from the implementation of legislation to improve domestic social and environmental standards—even when the legislation applies uniformly to all businesses, foreign and domestic. And the grounds for such claims appear to be expanding. For example, a European mining company operating in South Africa is challenging that country's black economic empowerment laws, seeking compensation from the government for being required to recruit a certain number of blacks for their workforce and board. Such cases can have a chilling effect on a developing country's attempts to improve its social and environmental performance without fear of being sued by foreign investors and having to pay them compensation for the privilege of meeting its obligations to its own people.

In turn, the legal framework that regulates TNCs operates much as it did long before the recent wave of globalization. A parent company and its

subsidiaries continue to be construed as distinct legal entities. Therefore, the parent company is generally not held liable for wrongs committed by a subsidiary, even where it is the sole shareholder, unless the subsidiary is under such close operational control by the parent that it can be seen as its mere agent. Furthermore, despite the transformative changes in the global economic landscape generated by far-flung networks of offshore sourcing, purchasing goods and services even from sole suppliers is still considered a transaction between unrelated parties. Factors such as these make it exceedingly difficult to hold an extended enterprise accountable for social and environmental harms inflicted by one of its units.

Of course, each legally distinct corporate entity is subject to the laws of the countries in which it is based and operates. But in most industries it has ready exit strategies. Moreover, states, particularly some developing countries, may lack the institutional capacity to enforce national laws and regulations against transnational firms doing business in their territory even when the government of the day has the necessary political will, or they may feel constrained from doing so by having to compete internationally for investment. In turn, the home states of TNCs may be reluctant to regulate against overseas harm by these firms because the permissible scope of national regulation with extraterritorial effect remains unclear in international law, or because the states' governments fear that those firms might lose investment opportunities abroad or relocate their headquarters.

Finally, this dynamic is not limited to TNCs. To attract investments and promote exports, capital-poor countries may exempt national firms from certain legal and regulatory requirements or fail to adopt such standards in the first place.

Recognizing the mounting challenge to their legitimacy, many of the world's leading TNCs have adopted their own private systems to manage various social aspects of their global operations, such as labor standards in their supply chains, or community engagement strategies in big-footprint natural-resource-extractive projects. Such voluntary initiatives are a positive development and help promote social standards. And they have important roles to play even in societies with well-functioning rule-of-law institutions and regulatory policies. But voluntary initiatives also have significant limits that need to be addressed and redressed. To state the obvious first, the vast majority of workers and communities live well beyond their orbit. However, even within their orbit, it is not unusual for workers in the same supplier factory, doing the same work, to be covered by different regulatory systems stipulated by different global buyers. This incongruity seems odd, to say the least, insofar as the rights in question are acknowledged to be universal.

These company-based systems are also highly variable. They may, but more often do not, meet internationally recognized standards even when those are explicitly invoked: in one case of what we might charitably term creative hermeneutics, freedom of association and collective bargaining were interpreted as "engaging in dialogue with employees about issues of mutual interest." Moreover, such voluntary systems vary in transparency, in what they reveal publicly about their inner workings and outcomes. Moreover, they vary in how proactive they are in anticipating and seeking to prevent problems, versus being reactive—typically, changing only when a company is confronted with some scandalous revelation in the press.

In addition, the driving forces that underlie the evident variability among corporate self-regulation include factors that have little to do with the substantive problems addressed, the specific populations involved, or the particular industry sector. In a recent survey of the Fortune Global 500 firms conducted by Ruggie, the specific rights recognized in a given company's corporate social responsibility (CSR) policy, and the external stakeholders that policy acknowledges, were found to be influenced decisively by the political culture of the company's home base, be it the United States, Europe, Japan, or emerging market countries.

At a more refined level of analysis, it is clear moreover that, among companies based in the same country and operating in the same industry, each firm's particular market segment strongly shapes the human-rights and broader CSR programs throughout its supply chains—the obvious comparison being between so-called premium brands, which trade on cachet, and value brands, whose consumers are concerned above all with price: the Nike–versus–Wal-Mart difference, in essence.

In sum, the existence of private corporate regulatory systems is surely a positive development. However, corporations' freedom to define both the form and the content of their regulatory systems and the high degree of market segmentation among such systems drastically limits their potential contribution to moving us toward an effective global business and human-rights regime, one that which would provide a sturdy social pillar to sustain the global market.

Multistakeholder initiatives and even collective business arrangements are typically clearer in the social standards they adopt and more transparent than private corporate regulatory systems. But in the end there is no substitute for governments doing what governments exist to do: to govern, and to govern in the public interest. Governments should not assume that they are helping business by failing to provide adequate guidance for, or regulation of, the adverse social impacts of corporate activities. On the contrary, the less governments do, the more they increase the risk to the reputation of the corporations that they

should legitimately regulate. Governments need to promote a corporate culture respectful of human rights and environmental sustainability at home and abroad. And they need to consider the impact on such standards when they sign trade and investment agreements, and when they provide export credit or investment guarantees for overseas projects in contexts where the risk to those standards is known to be high.

Embedding the International Financial System

International capitalism has always, paradoxically, had an uneasy relationship to capital itself. The international financial architecture—the collection of norms and rules that structure the interactions between governments and international financial markets—has changed dramatically more than once. Capital has alternately been extraordinarily free and fundamentally constrained as international capitalism has evolved over time. No arrangement or orthodoxy has been permanent, although illusions of permanence, inevitability, and inexorability have defined each historical moment.

The first era of globalization, circa 1870 to 1914, was built upon fundamentally liberal institutional foundations embodied in the practices of the classical gold standard. Policymakers understood that to restrict freedom of capital violated the rules, albeit unwritten, of the gold standard. With restrictions considered to be neither normal nor legitimate, capital was as free to flow from one country to another as it has ever been. Bankers, managers, and investors thus enjoyed an age of extraordinary freedom and opportunity.

The effects of the First World War, the decade of recurrent international financial crises that followed, and the Great Depression destroyed that liberal order. Then, during the 1940s and 1950s, the rules of the international financial architecture were rewritten to be restrictive by design and according to an explicit doctrine. At that time members of the international financial community collectively shared a set of beliefs about the destabilizing consequences of short-term, speculative capital flows, or "hot money," and the need for government autonomy from international financial markets. Only a few decades earlier, these beliefs would have been considered radical and anticapitalist. At the time, however, capital regulation marked capitalism's way forward.

To regulate and control capital became the prevailing orthodoxy. Policymakers then wrote their new consensus into the international financial architecture. The right of members of the International Monetary Fund (IMF), European Community (EC), and Organization for Economic Cooperation and Development (OECD) to regulate movements of capital was protected by the IMF's Articles of Agreement (1945), the EC's Treaty of Rome (1957), and the OECD's Code of Liberalization of Capital Movements (1961).

As the rules were liberalized in the decades that followed, managers and investors enjoyed another era of freedom, one that spurred massive growth in global financial markets. Freedom of movement for capital became the new orthodoxy once again. Instead of the unwritten rules of the first era of globalization, this new era espoused formal, codified rules that explicitly defined its liberal principles and policy practices. The rules of the European Union (EU) and the OECD were rewritten to oblige members, the world's thirty or so richest countries, to allow virtually all cross-border flows of capital. The IMF began informally to promote capital liberalization among its membership, which was nearly universal, and some policymakers sought to amend the Articles of Agreement to oblige members to liberalize capital movements. Central bankers meeting in Basel at the Bank for International Settlements (BIS) endorsed this liberal evolution of government practices, allowing banks to measure their own risks using models of their own design. A shadow banking system emerged, largely unregulated, perhaps half as large as the formal banking system. And private credit rating agencies, such as Moody's and Standard & Poor's (S&P), propagated the practices of this shadow system, and rather than blowing the whistle on excessive risk, they helped to disguise it.

Now once again a new orthodoxy of capital mobility has been undermined, this time by a wave of financial crises that struck emerging markets in the 1990s and, ultimately, by the panic of 2008—which has wiped out perhaps $30 trillion in asset values, and necessitating nearly $1 trillion in global write-downs so far. The EU, OECD, and IMF have since begun a general rethinking within the international financial community of the risks and benefits of capital liberalization. This rethinking has received ever more focused attention.

The United States must rethink its approach as well. Today, capital regulation once again marks capitalism's way forward. Regulation should aim at two objectives that informed capital's place in embedded liberalism: greater insulation of the real economy from the effects of financial crises; and greater policy autonomy from the short-term preferences of financial market participants.

These objectives have never been pursued for their own sake, but to permit and promote free trade in goods and, later, services by buffering the adverse effects of such freedom. Financial crises and wildly fluctuating exchange rates caused by perhaps excessively mobile capital and boom-and-bust cycles have in fact historically undermined the kinds of cross-border transactions that almost everyone has always believed would contribute to world growth and employment: simple, comparatively prosaic trade. Domestic regulations and the international financial architecture should be organized to privilege current-account transactions (and particularly trade in goods and services) over financial-account transactions.

The compromise of embedded liberalism also privileges the judgment of policymakers over those of financial market participants. Governments, according to this way of thinking, should be relatively autonomous from market forces, free to pursue expansionary monetary and fiscal policies without endangering their exchange-rate commitments or suffering the outflow of capital in search of a higher rate of interest or a lower rate of inflation.

With regard to the international financial architecture, then, international organizations should not promote—nor should their charters legally oblige—capital liberalization. National governments should fulfill their responsibilities to their citizenries and commit themselves to freer trade in goods and services, but requiring full capital liberalization without also creating effective regulatory underpinnings can undermine their capacity to do so. Such regulatory underpinnings can help prevent implicitly guaranteed financial institutions from taking excessive risks; limit the public's exposure to the risks that are inevitably taken, partly as a consequence of the circumvention of rules that necessarily tends to follow market innovations; and restrict credit and asset bubbles as they are forming. International organizations and their rules have proven far more effective at encouraging liberalization than at cultivating domestic institution building. They should also promote regulatory practices that have proven to be most effective, and allow for constrained and temporary deviation from openness when domestic needs require such a choice.

True, this implies that we will trust policymakers more than the financial markets, and doing so is never easy. During the 1920s and 1930s, the West learned to mistrust unregulated financial markets. And then we forgot. Today, we are relearning that lesson. Although the next generation of policymakers will no doubt forget it again, the need to re-embed the financial markets is, momentarily, crystal clear. Failing to do so will undermine the legitimacy of the entire enterprise of global capitalism itself.

Domestic regulatory systems, including that in the United States, should privilege the real economy over financial sectors. This will require real public oversight, rather than, as the United States has done for so long, the outsourcing of regulatory authority to rating agencies. More broadly, excessive credit creation and flawed compensation schemes drew managerial talent into activities that, in retrospect, have destroyed billions of dollars worth of value. A re-embedding of the financial system would also thereby temper a variety of adverse consequences of credit bubbles, which misallocate both capital and talent. We should be prepared to live with trading some extra financial innovation for a smaller crisis next time.

Reviving Multilateralism

The compromise of embedded liberalism was, lastly, based on multilateralism. Among the many advantages of multilateral decision making is the legitimacy of the deliberative process. Power usually is far more effective when exercised with consent rather than coercion. Multilateralism is self-interest for the farsighted. The convenience of unilateralism is ephemeral and ultimately self-defeating because of the reactions that it inevitably provokes.

Recall the point of view of Thrasymachus, in the first book of Plato's *Republic*. In a classic Socratic dialogue, Thrasymachus and his colleagues debate the concept of justice. Impatiently, Thrasymachus seeks to ends the debate with a power-politics sort of definition: justice, he says, is merely the will of the stronger. The strong define right from wrong, and the weak must live with the result.

U.S. policy has been based too much, and for too long, on this notion of Thrasymachean justice. The momentary usefulness of unilateralism has been far outweighed by the growing number of countries whose policymakers now prefer to impede progress on important issues based on the principle of opposing—in effect, balancing against—the United States. The American approach to ad hoc globalization has been self-defeating. Instead, multilateralism and governance through international organizations need to be revived if this global economic order is to be saved. This can be accomplished in two ways.

First, the United States should pursue its interests through organizations like the IMF and UN, rather than embrace the expediency of unilateralism or the power asymmetries of bilateral deal making. Whenever possible, bilateral treaty negotiations should be abandoned in favor of multilateral solutions, which, though they require more compromises, are longer-lasting arrangements.

Second, the voting weights of several of the major international organizations must change in order to reflect the economic realities of the twenty-first century. The IMF is the place to start, for the organization's voting weights, established in 1944, no longer reflect a world in which the capital-rich Middle East and Asia must be part of any conversation about how to cultivate the multilateral cooperation that is so urgently needed. This means that individual European countries and the United States will have to see their voting weights shrink.

Why should the West voluntarily give up voting power in such organizations? The answer is simple. In the future, the United States could, for example, have 17 percent of the weighted votes in an irrelevant IMF, or 14 percent in an organization that actually matters—and 17 percent of zero is still zero. And irrelevance is inevitable in the absence of change, in part because systemically important countries ranging from Brazil to China to the United Arab Emirates have been forced into the role of only being able to spoil multilateral negotiations that do not include them, rather than contributing to discussions that

reflect their needs and interests as well. Much the same is true of the UN Security Council, which now has two sets of permanent members: the P5, victors of World War II, with veto power; and a rotating bloc of "spoilers," whose driving motivation is to resist or undermine the decrepit hegemony of the P5 unless their immediate self-interest is advanced by it.

Cooperation will be essential in this next moment of the current era of globalization, and the United States is not in a position to demand or to force its emergence. It will have to emerge deliberately, legitimately, and multilaterally. The United States can maintain the ephemeral power of codified voting weights in dying organizations, or reinvigorate the organizations while taking roles better suited to the world in which we actually live.

Conclusions

"The world," Ernest Hemingway wrote, "is a fine place and worth the fighting for." His sentiment even holds true for the world economy, which has become in many ways more integrated than it ever has been. Globalization has helped to raise the living standards of millions; it has led to unprecedented opportunities for both societies and individuals. This integrated global economy is worth saving. The best way to save globalized markets is, perhaps paradoxically, to regulate them according to principles that, until very recently, have been very much out of fashion. Living in an era of neoliberalism, many of our policymakers lost track of the lessons of embedded liberalism. The result is paradoxical, for it was embedded liberalism itself that made possible the recent era of globalization through its embedded market practices—giving people the confidence that the risks of market opening would be shared. Social legitimacy—not neoliberal ideology—made the world safe for global markets. The influence of neoliberalism came late and was remarkably short-lived. The disembedding of markets and the asymmetrical rules governing TNCs have, more recently, undermined the very global project neoliberalism was meant to enhance.

Now this era of globalization must be saved, and not by the neoliberal ideology that led in significant part to globalization's current crisis of legitimacy. Rather, policymakers should return to the intellectual and normative framework that made the renaissance of global markets possible: embedded liberalism. The specific practices will need updating, but the core regulatory principle of this philosophy is essential: global markets require social legitimacy if they are to be sustained. That legitimacy derives from the embedding of market practices in the values and principles of national societies and, most broadly, in global civil society. In this essay, we have emphasized the relationship between social pillars and transnational business activity, the balance between the financial

markets and the real economy, and the political advantages of multilateralism. Many other issues fit within this framework.

The United States has, for some years, violated the regulatory principles and policy practices of embedded liberalism, and the result has not been satisfactory. Global markets have been rendered illegitimate, though the country needs those very markets. Skepticism is on the rise, though the United States has benefitted greatly from this era of globalization. The failure of neoliberalism presents an extraordinary opportunity for policymakers to credibly overturn one regulatory model in favor of another; perhaps this choice would have been politically impossible just a few years ago. Today the principles of embedded liberalism are clearly essential, and we need them more than ever.

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