Sustaining Democracy in the Era of Dependent Financialisation: Karl Polányi's Perspectives on the Politics of Finance

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Abstract. *With the contemporary crisis of liberal democracy and the rise of illiberalism in the aftermath of the global financial crisis we are witnessing a renewed interest in structuralist theories that conceptualise the inherent tensions of modernisation, crises and democracy. In my paper I attempt to show that Polanyi's thinking represents such a framework that can be updated to fit contemporary realities both in core and peripheral countries. I bring to the fore his often neglected views regarding the commodification of money and the tensions between international finance and democracy. I introduce the notion of dependent financialisation to make Polanyi's theory of money compatible with non-core capitalist economies. I conclude that Polanyi's theory of the double movement and fictitious commodification can only be understood and applied to empirical analysis once we bring it into dialogue with his political views. Polányi urges us to preserve the market by protecting the economy and society from the damages of excessive commodification: markets need to be protected from themselves.*

Keywords: POLANYI, DOUBLE MOVEMENT, FICTITIOUS COMMODITY, FINANCE, DEMOCRACY

Contents

1. Introduction

Financial crises impose immense economic, social and political losses. Financial crises might also lead to the rise of illiberal political forces. Przeworski (2000) has pointed out that the likelihood of a democratic breakdown is tenfold in an economic recession as compared with a state of economic growth. In a democratic polity economic woes have political repercussions. With the contemporary crisis of liberal democracy and the rise of illiberalism (Levitsky & Way, 2002; Zakaria, 1997) in the aftermath of the global financial crisis we are witnessing a renewed interest in structuralist theories (Iversen, 2009: 617) that conceptualise the inherent tensions of modernisation, crises and democracy. In my paper I attempt to show that Polanyi's thinking represents such a framework that can be updated to fit contemporary realities both in core and peripheral countries.

Polányi is mostly cited for his theory of 'embeddedness' (Barber, 1995; Gemici, 2008), however, his views on democracy and financial liberalisation are rarely invoked. Yet, Polanyi has offered several prescient thoughts on the fictitious commodification of money that could serve as a valuable theoretical frame to analyse contemporary tensions between financial markets and democracy. Economic anthropologists have long recognised the value of Polányi's work in understanding the nature of money (Graeber, 2009; Hann & Hart, 2011; Hann, 1992; Hart, 2009). However, most of these works have concentrated on his later writings and mainly took Polányi's article *The semantics of money uses* as point of reference (Polanyi, 1971). As Saiag (2014) shows, *The Great Transformation* differs from his later writings on money in several dimensions, but most importantly, in its analysis of money as part of the historical process of the rise and fall of the fiction of free markets and fictitious commodification.

More recently, several leading post-Marxist scholars have tried to revive Polanyi's theories to reconstruct critical theory. Fred Block and Margaret R. Somers (2014) argue that Polanyi could be the central figure of renewing contemporary Left-wing thinking, echoing Burawoy's (2003) call to reconstruct Marxism on a sociological ground based on Gramsci and Polanyi. Social movement theorists have also rediscovered Polanyi's notion of the double movement to conceptualise movements fighting for a counter-hegemonic globalisation (Evans, 2008; Munck, 2004).

In my article I join the recent scholarship on Polanyi that aims to bring his theory of money to understanding the politics of contemporary financial crises (Block, 2015; Harmes, 2001;

Helleiner, 2006; Holmes, 2014; Kara, 2014; Polanyi-Levitt, 2005, 2013; Woodruff, 2016). This literature focuses on the core capitalist countries, mostly the eurozone. By introducing the notion of *dependent financialisation* I show that Polanyi's theory can be updated to analyse structural tensions between financial markets and democracy in semi-peripheral countries even without the presence of a fixed exchange rate or an outright currency union like the eurozone. Polanyi was the first political economist to link international financial liberalisation to the erosion of democracy. He was also one of the first to forcefully argue that proponents of freedom have to regulate the free market to protect not only society but the productive process itself otherwise wholesale attacks on the institutions of freedom seem to be inevitable. In my paper I intend to show that Polányi was deeply committed to the principles of freedom and democracy, and his critique of marketisation was not meant to completely overhaul the institution of the market but to embed it into social regulation to reconcile it with democratic sustainability. The thrust of Polányi's argument about the perils of fictitious commodification is that democracy can only be sustained if the operation of the market in general and money in particular is embedded into regulation. Failing to recognise this interrelation leads to the rise of antidemocratic forces according to Polányi.

The paper proceeds as follows: In the next section I will bring to the fore his views regarding the commodification of money and the tensions between international finance and democracy as laid out in *The Great Transformation*. In the third section of the paper I introduce the notion of dependent financialisation to show how the structural tensions inherent to liberal finance analysed by Polányi can be applied to semi-peripheral countries even without a fixed exchange rate regime. The Polányian theory of money allows us to formulate hypotheses about political dynamics in different varieties of capitalism. In the final section of my paper I conclude that Polanyi's theory of the double movement and fictitious commodification can only be understood and applied to empirical analysis once we bring it into dialogue with his theory of democracy. Democracy can only be sustained in the era of dependent financialisation if society reasserts control of money and democratises the economy.

2. The great transformation of money

In *The Great Transformation* Polanyi showed that liberal economists have mistaken labour, land and money as commodities leading to a complete misunderstanding of the working of the economy. Therefore, following what Polanyi (1957) later called the substantive view of the economy, economic analysis has to transcend the focus on efficient use of scarce resources and become sensitive to history and social embeddedness of the market. *'Fictitious commodification'* is one of the central elements of Polanyi's theory about capitalist crisis. It is not only morally wrong to treat land, labour and money as commodities, but leaving these spheres completely to the market also leads to a breakdown of the functioning of the market and society. Market societies therefore need the state and thus need some form of political decision making to guide state involvement in the economy. Society will in some way react to the imposition of a fictive free market leading to what Polanyi calls '*the double movement'*. For Polanyi, the most important element of this historical development was in the sphere of *money*. Money is at the centre stage of his historical account of the rise and fall of liberal capitalism. Speaking about the collapse of the order of peace, the collapse of global capitalism and the rise of fascism he writes 'the gold standard proved crucial; its fall was the proximate cause of the catastrophe' (Polanyi, 2001[1944]: 3).

Polanyi's approach to international monetary affairs is clearly at odds with the classical view that separates the 'monetary' and 'real' spheres of the economy. Much of the mainstream analytical efforts to understand money treated it purely as a neutral expression of exchange value. According to this orthodox view of money there are no particular political preconditions and no major political implications of money, that is, money is neutral. *The Great Transformation* questions this view of money and places it in the history of the development of market society as a fictitious commodity. For Polanyi, both the rise and fall of the market system and the political challenges induced by the fixed exchange rate regime of the gold standard cannot be analysed separately from monetary policies and the collective representation of money. In his theory of money Polanyi thus departs both from the subjectivist theory underpinning neoclassical economics and the labour value theory underpinning classical and Marxist economics (Maucourant, 2001). Polanyi's approach to money is non-essentialist and institutionalist: he treats the economy and money as an institution that expresses empirical regularities of social life and as such is linked to the existing social order. From this it follows that money might take different forms and have different functions in society.

In his later writings Polanyi made an analytical distinction between 'special purpose money' and 'all purpose money' (Polanyi, 1957, 1971), maintaining that money had various functions in non-modern societies but in modern market society money has become 'all purpose money'

(Melitz, 1970). This view of money in market society differs from that of *The Great Transformation* that treats money as an historically specific institution in modern societies that has social and political functions and cannot be conceptualised as a universal means of exchange (Saiag, 2014). I agree with Holmes (2014) that we need to follow the logic of *The Great Transformation* and adhere to the special purpose view of money. This way we can conceptualise the power relations within which money as a social relation functions: money is more than a universal means of exchange, it can be a unit of accounting (for debt), purchasing power and also a disciplinary tool of neoliberal governmentality. In fact, as Polanyi points out, economic liberals also recognised the limitations of the view of money as a universal means of exchange and thus a commodity.

As Polanyi describes in the first chapter of *The Great Transformation*, the only exception where liberals tended to openly accept state intervention was the sphere of money. Stable exchange rates between national currencies were central to maintaining the liberal order of the 19th century, thus the protection of the exchange rate became one of the most important tasks of governments. Monetary stability was considered a prerequisite for the international expansion of the market, without which the free international movement of goods and capital could easily be jeopardised by sudden movements of the exchange rate. During the first era of globalisation in the 19th century, international financial investments (in the forms of railways, colonial companies, or international lending) grew to an unprecedented scale. Polanyi argues that international investors of the era – haute finance as he calls this faction of the economic elite – became strongly interested in the maintenance of peace and monetary stability. They were able to put pressure on governments – who would by themselves not be too much concerned with international peace – through the lever of lending. Thus the system of fixed exchange rates was born representing the highest form of the *fictitious commodification of money*. Yet, money has not been produced solely to function as a universal means of exchange. The whole working of the economy rests on it, therefore the quantity and price of money cannot be decided through the market as that would undermine the working of democracy:

> Yet if profits depend upon prices, then the monetary arrangements upon which prices depend must be vital to the functioning of any system motivated by profits. […] Hence, if the price level was falling for monetary reasons over a considerable time, business would be in danger of liquidation

> accompanied by the dissolution of productive organisation and massive destruction of capital (Polanyi, 2001[1944]: 201)

The creation of the fictitious commodity of money – just as the creation of labour and land as commodities – required a new bureaucratic state and a series of new regulations to protect the functioning of the economy itself. Not only was the creation of the gold standard a result of deliberate political action, but so was the emergence of central banking to ensure the smooth running of the money market. Hence the remark by Polanyi: "*laissez faire was planned – planning was not*" (Polanyi, 2001[1944]: 147). The establishment of the gold standard and the free movement of money not only created problems for the producers but it often involved painful internal adjustment to preserve the value of money and protect fixed exchange rates. Fluctuations in economic processes induced by unchecked market forces went beyond the endurance of society calling forth protective measures of various kinds, from social insurance through social policies to tariffs and protectionism. Polanyi also notes how an internationally interconnected system of national economies might exaggerate these problems:

> Under the gold standard—which we all the time assume to be in force—any governmental measure that caused a budgetary deficit might start a depreciation of the currency; if, on the other hand, unemployment was being fought by the expansion of bank credit, rising domestic prices would hit exports and affect the balance of payment in that way. In either case exchanges would slump and the country feel the pressure on its currency.' (Polanyi, 2001[1944]: 209)

The collapse of 19th century liberalism and the rise of fascism cannot therefore be understood without looking at the liberalised international economic system of the 19th – early 20th centuries also encompassing an analysis of the interaction between fixed exchange rates and the inability of the government to react to international economic disturbances and unemployment. Polanyi clearly understood this dynamic interrelatedness of democratic politics and social protection against the effects of international free markets and the exchange rate. As Holmes (2014: 585) points out, the contradictory goals of sustaining the gold standard and defending the domestic economy led to the final collapse of the gold standard system. Nationalism and the ideology of autarchy took the place of liberal internationalism. There was no international mechanism to protect the economy (the Bretton Woods

Institutions were established decades later), therefore national solutions became the only possible form of social protection against the fictitious commodification of money.

The collapse of the gold standard thus was not a result of errant politicians choosing bad policies or self-interested workers looking for protection but rather was an inevitable result of the imposition of the fictitious commodity of money upon society. The countries that were able to survive the thirties with the least inclination to succumb to illiberal forces were the countries first to abandon the gold standard. In the US, the New Deal would have been impossible without the country leaving the gold standard system. Polanyi also points out that in the case of macroeconomic adjustment through internal deflation liberals in effect chose the principle of price stability and the maintenance of the value of the currency and the gold standard over non-intervention and advised governments to push for the reduction of wages:

> The stubbornness with which economic liberals, for a critical decade, had, in the service of deflationary policies, supported authoritarian interventionism, merely resulted in a decisive weakening of the democratic forces which might otherwise have averted the fascist catastrophe. Great Britain and the United States—masters not servants of the currency—went off gold in time to escape this peril.' (Polanyi, 2001[1944]: 242)

Polanyi described three major reactions to the Great Depression. In Central Europe, most notably Germany, the contradicting demands of different classes lead to a high levels of debt and a democratic stalemate. Neither the rentier class nor the workers could prevail, inducing a prolonged political crisis and a loss of confidence in democratic politics and thus paved the way to fascism. Fascism according to Polanyi was the negation of democracy and the upholding of capitalism resulting in a disciplinary state. In England, according to Polanyi, democracy could be sustained only because the rentier class was able to defeat the working class politically. Investors thus did not have to fear a political backlash against their interests and could abandon the gold standard to which they had insistently adhered until the fall of the labour government and the failure of mass strikes. Finally, the third way according to Polanyi was that of the United States where Roosevelt building on the restructured Democratic Party was able to defeat the interests of Wall Street politically and abandon the gold standard.

Polanyi thus suggested that by opening up national economic decision making to parties representing working-class interests through the extension of the right to vote clearly played an important role in the fall of the gold standard system. However, the interplay of global finance and domestic politics did not necessarily lead to the collapse of democracy and the rise of fascism. The fate of democracy rested on the fate of the gold standard – the central expression of the fictitious commodification of money. Governments that went off the gold standard were able to retain democracy. Polanyi points out that the common external factor of the gold standard led to divergent political outcomes in different countries based on local economic and political histories and different policy choices. By abandoning the gold standard and subjecting money to political control, democracy could be rescued. This solution depended on the balance of class forces and the different varieties of societal organisation leading to divergent outcomes in response to the Great Depression. 3. The political trilemma of dependent financialisation

3. The political trilemma of dependent financialization

Contemporary economists have produced several waves of theories of financial crises, most of them unaware of Polanyi's prescient analysis provided in *The Great Transformation*. Yet, Polanyi's theory is still relevant and can be updated to fit contemporary realities. In a similar fashion to the gold standard, currency pegs and currency unions (binding the exchange rate of one currency to the other) were widely recommended throughout the eighties and nineties to developing countries in the framework of the Washington Consensus. Reinhart and Vegh (1999) find that in most cases exchange based price stabilisation was much slower than expected from the fixed exchange rate currency regime. The persistence of inflation differentials however leads to real overvaluation and seriously destabilises the domestic economy through the loss of competiveness. The slow convergence of inflation rates fuels a large real exchange rate appreciation which, together with the fall in private saving, leads to large current account imbalances and over-borrowing. This situation brings the Polanyian tensions of the commodification of money to the fore again.

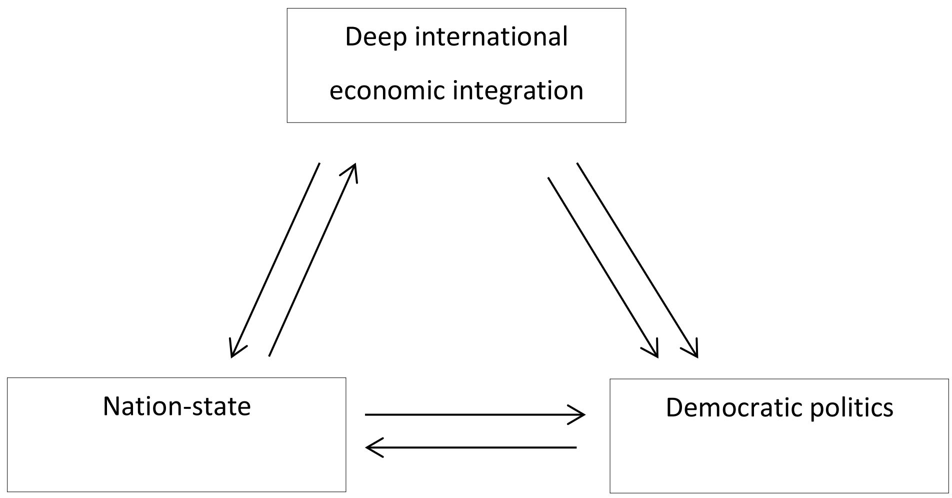
Governments might react in two ways to such a loss of external competitiveness under a fixed exchange rate regime. The first type of reaction follows the suggestion of liberal economists – similarly to the economists analysed by Polanyi – to maintain the exchange rate which requires an internal devaluation to restore competitiveness: cutting wages, cutting social spending, decreasing pensions and cutting internal consumption. The fall in internal prices would restore competitiveness, boost exports and thus the crisis would be overcome. However, workers – as analysed by Polanyi – are reluctant to accept cuts to wages, and their resistance could lead to increasing unemployment and increasing public spending. Internal devaluation, a deflation of prices is always a painful measure to restore international monetary balance. Democratic governments, especially Left-wing governments relying on the votes of those hurt by deflation, are reluctant to allow such adjustment and are inclined to protect society from the pressure emanating from international financial markets. A second possible reaction to the problem of the loss of international competitiveness and currency overvaluation is not internal devaluation but external devaluation through a change in the value of the currency. However, this requires monetary policy autonomy to modify the exchange rate and this autonomy is not present in the system of fixed exchange rates as the gold standard of the 19th century or today's euro and other currency pegs.

Among contemporary economists it was Barry Eichengreen to first note the usefulness of Polanyi's analysis of the collapse of the gold standard and the embeddedness of the monetary sphere into political processes. Inspired by Polanyi, Eichengreen (1996) points out that the stability of the nineteenth-century gold standard was possible because of the lack of mass democratic politics and the insulation of economic policy-making from democratic pressures. Before the mass extension of the franchise it was easier for governments to orchestrate internal deflation of prices as the social repercussions were not directly felt politically. The international macroeconomic model of the impossibility trilemma developed by Dani Rodrik goes even further in integrating political and economic analysis.

In his paper *The Governance of Globalisation* Rodrik (2000) describes the political trilemma of the world economy as the impossibility to simultaneously pursue deep international economic integration, democratic mass politics and the sovereignty of the nation-state. According to the model, we have to choose either to curb integration to retain the nation-state and democratic politics; or maintain integration and the nation-state but abandon democratic politics; or to say farewell to the nation state and re-create democracy and the international level. As opposed to Polanyi, Rodrik thinks in terms of good policies and not in power relations that bring about various institutional orders. Rodrik's model is analytically more rigorous but static, whereas Polanyi's account of the great transformation was less rigorous but more dynamic. We need to be able to conceptualise the trilemma not as a theoretical impossibility of policy choices but as a dynamically evolving tension among the state, international capital flows and democracy that is driven by the structural dynamics of the changing balance class forces. This trilemma can be played out differently according to divergent local political structures. The double movement emanates from the political trilemma but takes different forms in different countries. Combining Rodrik and Polanyi offers a theoretically sophisticated understanding of the various ways in which external and internal political and economic forces shape each other. Figure 1 describes this modified trilemma as updated by the Polanyian notion of double movement.

Democracy, state autonomy and deep international economic integration are incompatible goals, and imposition of the fiction of free markets leads to social protective mechanisms. Similar political tensions have surfaced with the crisis of the eurozone (Holmes, 2014; Kara, 2014; Woodruff, 2016). Yet, it does not require a fully fledged currency union or a fixed exchange rate for the tensions of fictitious commodification to surface. After the collapse of the Bretton Woods system a new era of liberal finance has started as was described by the literature on financialisation (Davis & Kim, 2015; Epstein, 2005).

Figure 1 The double movement dynamics of the political trilemma



There are significant differences in the way various countries of the European periphery developed their vulnerabilities and reacted to crises. Political structures diverge, different varieties of capitalism (Bohle & Greskovits, 2012) allow different resolutions of the political trilemma inherent to dependent financialisation. The tradition of identity politics in the Baltic states allowed more space for political toleration of internal devaluation as opposed to Hungary for example. The trilemma not only developed in countries with fixed exchange rates but in countries where foreign currency debt tied the hands of monetary authorities. Bound to the rule of the free flow of capital in the EU and unable to significantly devalue their currencies due to high levels of private foreign currency debt the only option for the government in

Hungary was to follow the logic of deflation: cut budgetary expenses and decrease real wages. The fictitious commodification of money, the uncontrolled flow of cross-border debt and emergence of institutional infrastructure of liberal finance pitted the logic of democratic politics against the maintenance of the confidence of investors. We can conclude with posing the hypothesis that the collapse of the Hungarian Left and the rise of illiberalism can be understood using Polanyi's notion of the double movement as a reaction to the commodification of money in the form of dependent financialisation. New empirical research is needed to test this hypothesis.

4. Conclusion

Polanyi's analysis of the collapse of the gold standard has many important implications for today's financial crises and the resulting pressures on democracy. Without meaningful intervention and financial assistance to those countries that got into deep trouble during the crisis with their fixed exchange rates, a democratic collapse and a rise of political forces negating freedom can be the result. Fictitious commodification creates similar tensions under the regime of the gold standard, the eurozone or dependent financialisation. The crucial question politically as well as analytically is what form the regulation of free markets will take and in what form the double movement emerges. Although monetary policy seems to be a technical problem better left to experts, applying the framework of Polanyi we are able to transcend the narrow focus of classical economics and realise that monetary policy is in fact deeply political with major social implications.

Bringing Polanyi's theory of the double movement into dialogue with his political views we can formulate a non-functionalist theory of the double movement. For Polanyi, democracy is only complete if the economy is democratised. If the economy is separated from politics then the power of capital prevails thus reducing the equality of citizens into a mere façade disguising the rule of economic interests. Central to Polányi's critique of economic liberalism is his ideal of positive or substantial freedom (on the idea of positive freedom see Sen, 1999). Polányi considers it to be a grave error to mistake freedom for free markets, for the lack of state involvement. To prevent fascism democratic forces need to abandon the illusion of the self-regulating market and endorse regulation and planning to re-embed the market into society (Polanyi, 1935). According to Polányi, human freedom and the functioning of the market both require state involvement into economic affairs. The notion of freedom as a lack of state interference as propagated by orthodox economic liberalism conceals '*such brutal restrictions of freedom as were involved in the occurrence of unemployment and destitution*' (Polanyi, 2001[1944]: 266).

Individual freedom (especially 'the right to non-conformity') must be guaranteed in democratic socialism but this can only be achieved if we depart from the notion of freedom as free enterprise into which the liberal idea degenerated according to Polányi. Freedom can only be fulfilled in and through society: democratic society has to be organised in a transparent way so as to provide ground for the informed and responsible intervention of individuals, who thereby achieve a new and "positive" form of social freedom (Cangiani, 2012: 45).Therefore, institutions of planning and redistribution at the root of the welfare state, have to be embedded into social and communal coordination according to Polányi to preserve freedom. As a democratic socialist, he believed that freedom can only be guaranteed through social or communal regulation. For Polányi

> 'socialism is, essentially, the tendency inherent in an industrial civilisation to transcend the self-regulating market by consciously subordinating it to a democratic society (2001[1944]: 242).

His critique against economic liberalism is based on a positive theory of freedom that can be maintained only if the economy is subjected to political control. Yet, his insistence on a non-economistic conception of democratic socialism is crucial to avoid the pitfalls functionalism that Polanyian analyses of globalisation and resistance often fall into. There is no preordained movement against commodification: the outcome of political struggles depends on political organisation. This democratic autonomy of the political sphere against democracy can only be fulfilled if it is used to re-embed the economy into social control. To prevent fascism democratic forces need to abandon the illusion of the self-regulating market and endorse regulation and planning to re-embed the market into society (Polanyi, 1935). Although he was sympathizing with the socialist movements of the era, in his most prominent political speech delivered at the convention of the Radical Party in 1918 in Szeged Polányi gave a succinct overview of the programme and strategy of the party and also juxtaposed it to the 'scientific socialism' of contemporary Marxism (Polanyi, 1986b).

In the closing section of *The Great Transformation* Polanyi points out that both fascism and socialism were representatives of the double movement toward social protectionism, but whereas fascism rested on complete negation of freedom, the theory of socialism was built with freedom at centre stage. For Polanyi, socialism essentially means democratic socialism, a strong from of social democracy, with the preservation of markets within a system of public regulation, social protection and planning. It is a question of local social characteristics, local path dependencies and local histories of class formation and ideological struggle what form the double movement will take. It might induce the rise of illiberal forces, it might result in pervasive withdrawal from politics or might give rise to new progressive forces aiming to deepen democracy through curtailing the fictitious commodification of money. Herein lies the potential of a Polanyian analysis of the commodification of money and the divergent reactions to it.

By securing social rights, supporting trade unions to fight for higher wages, providing public services and social insurance the social burden of international macroeconomic shocks might be eased. However, this will also necessitate the abandonment of completely liberal global financial markets and a return to capital controls and managed exchange rate regimes, and the introduction of international wealth and transaction taxes (e.g. Tobin-tax) as well as strong national and international regulation of lending to curtail the fictitious commodification of money. This way, society, democratic politics and the market based system of production might be protected from the negative effects of fictitious commodification. The real option against illiberalism for political liberals and democratic socialists is to uphold freedom against the illusion of the free market and fictitious commodification to protect society from the market:

> 'The discovery of society is thus either the end or the rebirth of freedom. While the fascist resigns himself to relinquishing freedom and glorifies power which is the reality of society, the socialist resigns himself to that reality and upholds the claim to freedom, in spite of it.' (Polanyi, 2001[1944]: 268)

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