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often wrong and that the single most important function of government was to manage the economy, by taming and controlling unstable market forces.

Capitalism 3, the Thatcher-Reagan monetarist counterrevolution that culminated in the Bush–Greenspan market fundamentalism described in this book as Capitalism 3.3, adopted the opposite approach. Instead of treating economics as a branch of politics, it treated politics as a branch of economics. Its most important leaders believed that governments were usually wrong and always inefficient; therefore markets should be empowered wherever possible to discipline and control venal politicians.

Assuming that the era of market fundamentalism ended with the 2007–09 crisis, what should we expect as the defining characteristic of Capitalism 4? It will probably be a recognition that governments and competitive markets can both be wrong and that the world is too unpredictable and complex to be managed by any immutable institutional structure. This conclusion may seem paralyzing and depressing, but it is actually empowering. If markets and political institutions are both recognized as fallible, the rational response must be a willingness to experiment and a preference for reversible policies and business decisions, initially conducted at a modest scale and in a decentralized way. Luckily, such decentralized experimentation is consistent with both modern technology and social trends. The benefits of small-scale reversible experimentation are already becoming visible in business, social policy, and even diplomacy. The postcrisis transition from the hubristic dogmas of neo-conservative market fundamentalism to the humble scepticism of Capitalism 4.0 should promote and accelerate these trends.

Before imagining how capitalism might evolve in the future, however, we need to look more closely at the present and the past. We have to do this to answer the question left hanging earlier in this chapter: If economic history does progress through once-in-a-generation seismic changes, has the world just witnessed such a sudden break? Part II tries to answer this question by putting some historic and theoretical context around the extraordinary events of 2007–09. To prepare the ground requires a fuller stylized history of capitalism, which the next chapter provides.

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CHAPTER THREE

The Four Ages of Capitalism

The lion, the tiger, and the leopard are three species of the same genus—obviously different and obviously alike.

THE WORD *capitalism* in its modern sense is only 150 years old.[1] But the two human characteristics on which it is founded are universal, stretch back into the mists of history, and explain why efforts to replace the chaos and injustice of the markets with more rational or moral systems have always failed. These two basic human qualities are the competitive spirit (ambition) and the desire for sensual gratification and mastery of the material world (which can be described pejoratively as greed). However, these emotions are not sufficient to define capitalism. As expounded by Max Weber in his classic *The Protestant Ethic and the Spirit of Capitalism,* there are two additional requirements: acceptance of profit and capital accumulation as motives with genuine moral legitimacy, as opposed to deplorable, though ineradicable, human vices; and the recognition of voluntary exchange and cooperation, rather than heredity and coercion, as the main organizing principles of economic life.[2]

These concepts emerged from the Calvinist ideology of the late seventeenth century, according to the standard view of social history pioneered by Weber. But they were crystallized by Adam Smith in *The Wealth of Nations,* producing some astonishingly counterintuitive revelations. Smith observed that a market economy, although it involves millions of unconnected individuals who work at highly specialized and narrow tasks, is a naturally self-organizing mechanism provided a few simple rules of commerce and mutual trust are generally obeyed and enforced. This self-organizing system produces mutually satisfactory outcomes as if it were guided by an "invisible hand," but without the need for supernatural or divine intervention. And individuals, as long as they act predictably within this mutually agreed social framework, can satisfy each other's material needs simply by pursuing their own self-interest. To provide useful services to other people, we do not need to know them, love them, or anticipate their desires. As Smith said: "It is not from the benevolence of the butcher, the brewer, or the baker that we expect our dinner, but from their regard to their own self-interest."[3]

The miraculous efficiency of the market system, taken for granted everywhere today, was far from obvious to half of humanity just a few decades ago, as illustrated by the famous, though probably apocryphal, anecdote about Nikita Khrushchev's first trip to the United States. The Soviet leader, after visiting some supermarkets in Manhattan and finding them filled with fresh food, in contrast to the empty shelves of Moscow, turned to his host, Vice President Richard Nixon, and asked, "Who is responsible for the supply of bread to New York City? I want to meet this organizational genius." In *The Company of Strangers*, a brilliant book about the roots of economic cooperation in the biology of human evolution, the Anglo-French economist Paul Seabright delightfully describes the wonder that market forces ought to inspire:

> This morning I went out and bought a shirt. There is nothing very unusual about that; perhaps twenty million people did the same. What is more remarkable is that I, like most of those twenty million, had not informed anybody in advance . . . Yet the shirt I bought, although a simple item by the standards of modern technology, is a triumph of international cooperation. The cotton was grown in India, from seeds developed in the U.S., and the material in the dyes came from at least six other countries . . . the machinery for cutting it came from Germany and the shirt itself was made up in Malaysia. The project of making a shirt and delivering it to me has been a long time in the planning. And yet nobody knew I would be buying a shirt of this kind today . . . If there were any single person in charge of supplying shirts to the world's population, the challenge facing them would bring to mind the predicament of a general fighting a war. One can imagine an incoming president of the United States being presented with a report entitled 'The World's Need for Shirts,' trembling at the contents and immediately setting up [a] Presidential Task Force. . . . The Pope and the Archbishop of Canterbury would issue calls for everyone to pull together to ensure the world's shirt needs were met.
>
> Citizens of the industrialized world have lost their sense of wonder that they can go out spontaneously in search of food, clothing, furniture, and thousands of other useful items and . . . somebody will have anticipated their actions, and thoughtfully made such items available for them to buy. For our ancestors, who wandered the plains in search for game, or scratched the earth to grow grain under a capricious sky, such a future would have seemed truly miraculous, and the possibility that it might have come about without the intervention of any overall controlling intelligence would have seemed incredible.[4]

Adam Smith's pioneering analysis and explanation of this miracle was published in the spring of 1776.[5] By a telling coincidence, it was on July 4 of the same year that the U.S. Continental Congress issued its Declaration of Independence, creating the first self-consciously capitalistic nation—one that was quickly to become the incomparably successful paragon of economic and social progress and eventually to set the standard for political development for all other nations around the world.

To establish the dominance of the broad politico-economic model created by these breakthroughs took forty years of war and revolution—the American War of Independence, the French Revolution, and the Napoleonic Wars. But from the Battle of Waterloo in 1815 onward, the increasingly liberal political and economic systems established in America and Britain spread rapidly to Europe and, by way of the age of imperialism, to the rest of the world. This system of classical imperialist capitalism, underpinned by British and American politico-economic thinking, prospered for roughly one hundred years, until the period of disintegration that started with World War I in 1914 and climaxed with the Great Depression and World War II. This age of classical capitalism could be subdivided into several subperiods, marked out by financial and military crises:

Capitalism 1.0: from 1776, the U.S. Declaration of Independence and *The Wealth of Nations*, to 1815, the defeat of Napoleon at Waterloo
Capitalism 1.1: from 1820 to 1849
Capitalism 1.2: from 1848–49, Europe's Year of Revolutions, the repeal of the Corn Laws, and the Navigation Acts, until the late 1860s, during the aftermath of the U.S. Civil War and the Franco-Prussian War
Capitalism 1.3: from 1870 to 1914, the United States' Gilded Age or the Second Industrial Revolution
Capitalism 1.4: from 1917 until 1932, the period of disintegration, when capitalism came closer to genuine collapse than ever before or since

Some of the upheavals that punctuated the transitions from one of the subperiods to another were bloody and traumatic—for example, the American Civil War and the slaughter of the Paris Commune—but they did not turn out to be systemically transformational crises of capitalism, as described in Chapter 2. Nevertheless, serious historians will justifiably point out that the 150 years from 1776 to 1929 saw more radical political and economic changes than any previous period in human history and thus it is ludicrous to lump them together into a single epoch—and if this were a work of history they would be right. But economics relies on simplifications and stylized facts. And one consistent theme ran through all the politico-economic variations of the nineteenth century and justifies, at least for this discussion, the single label of Capitalism 1.

This entire epoch had in common a clear and unquestionable ideology: a belief that the capitalist system based on private property and the profit motive was an elemental force of nature, governed by iron laws of economics that were as immune to human manipulation as a hurricane or a tidal wave.

The general philosophy of laissez-faire[6]—a belief that economics and politics are two distinct spheres of human activity and emotion that must

remain as distinct as possible in the interests of both economic and political progress—was dominant throughout this 150-year period. Government intervention in the economy was quite extensive, mainly through high and variable trade tariffs and excise taxes. These were used not only for raising revenues, but also for what would now be described as protectionist industrial policies to favor influential industries or social interests, such as textile manufacturers or yeoman farmers. But economic thinkers were virtually unanimous in believing that such government interventions were relics of a precapitalist feudal period and were destined to disappear.

Protectionist or paternalistic precapitalism was seen not as a serious long-term rival, but as a temporary roadblock to the onward march of liberalism and free trade.[7] The only alternative to classical laissez-faire capitalism—and one that was viewed seriously as a potential rival—appeared to be the abolition of private property, money, and even mankind's competitive instinct, predicted not only by Marxists but also by anarchist revolutionaries, Utopian Christians, and socialists of many stripes.

In one crucial respect, however, the friends and foes of capitalism were alike. Neither side had any concept of a governmental duty or capacity to create jobs, support private industries, guarantee the soundness of financial institutions, or stabilize economic cycles. To the extent that government impinged on private business, it was as a judicial disciplinarian or sometimes a predatory looter. A strong and well-organized state was needed to enforce contracts and protect private property, but an overweening state would stunt economic progress by favoring politically powerful vested interests and by squeezing private enterprise for revenues to support aristocratic luxury or to fight wars.

For most nineteenth-century thinkers, therefore, government was considered most legitimate when confined to what the French called the regalian responsibilities of the state: justice, lawmaking, and national defense, to which liberal thinkers gradually added the provision of basic education and relief from extreme poverty and physical exploitation.[8] Managing economic activity and employment was emphatically not among these regalian duties—and this disconnect between government and the economy was something everyone could agree on, from bourgeois liberals and conservative oligarchs to Marxist revolutionaries and Utopian social-democrats.

The last, most successful phase of Capitalism 1—and the one that came nearest to the laissez-faire ideal—began around 1870. More precisely, it can be dated from the late 1860s, a remarkable period that witnessed the end of the U.S. Civil War and the abolition of slavery (1865), Britain's Second Reform Act (1867), which dramatically extended voting rights, and the start of the Second Industrial Revolution, a period of dramatic economic acceleration from around 1860 onward, based on the new technologies of electricity, chemical engineering, and petroleum. This triumphant decade of accelerating progress was also, ironically, the age when classical capitalism suddenly seemed under the greatest threat. Despite the technological and social progress, this period also saw an upsurge of anticapitalist thinking and action with the publication of Marx's *Das Kapital* (1867); the foundation of the first American trade union (1869), the Knights of Labor; and the revolutionary uprising of the Paris Commune in 1871.

These social and technological upheavals, far from undermining capitalism, laid the foundation for a period of unprecedented prosperity and peace that Keynes described in a poetic passage suffused with his characteristic blend of irony and affection: "After 1870, there was developed on a large scale an unprecedented situation [of rising living standards and expanding production] . . . In this economic Eldorado, in this economic Utopia, as the earlier economists would have deemed it, most of us were brought up."[9] It is impossible to better Keynes's wistful evocation of capitalism's exuberant spirit in this prelapsarian Golden Age:

> What an extraordinary episode in the economic progress of man that age was which came to an end in August, 1914! The greater part of the population, it is true, worked hard and lived at a low standard of comfort, yet were, to all appearances, reasonably contented with this lot. But escape was possible, for any man of capacity or character at all exceeding the average, into the middle and upper classes, for whom life offered, at a low cost and with the least trouble, conveniences, comforts, and amenities beyond the compass of the richest and most powerful monarchs of other ages. The inhabitant of London could order by telephone, sipping his morning tea in bed, the various products of the whole earth, in such quantity as he might see fit, and reasonably expect their early delivery upon his doorstep; he could at the same moment and by the same means adventure his wealth in the natural resources and new enterprises of any quarter of the world, and share, without exertion or even trouble, in their prospective fruits and advantages; or he could decide to couple the security of his fortunes with the good faith of the townspeople of any substantial municipality in any continent that fancy or information might recommend. He could secure forthwith, if he wished it, cheap and comfortable means of transit to any country or climate without passport or other formality, could despatch his servant to the neighbouring office of a bank for such supply of the precious metals as might seem convenient, and could then proceed abroad to foreign quarters, without knowledge of their religion, language, or customs, bearing coined wealth upon his person, and would consider himself greatly aggrieved and much surprised at the least interference. But, most important of all, he regarded this state of affairs as normal, certain, and permanent, except in the direction of further improvement, and any deviation from it as aberrant, scandalous, and avoidable. The projects and politics of militarism and imperialism, of racial and cultural rivalries, of monopolies, restrictions, and exclusion, which were to play the serpent to this paradise, were little more than the amusements of his daily newspaper, and appeared to exercise almost no influence at all on the ordinary course of social and economic life.[10]

As he wrote those words in 1919, Keynes clearly saw that classical capitalism was dying after the mortal blow of the Great War. But even he did not fully imagine how venomous were the serpents that had bred in the lost Eden he evoked. Far more insidious than the monopolies and cultural rivalries he mentioned were the monsters of communism, fascism, and class conflict, fed by the widening inequalities of nineteenth-century capitalism, which finally become intolerable after the shared sacrifices of the World War. As Keynes's bourgeoisie were sipping their tea in bed and chancing their fortunes on foreign ventures, the working classes in the prewar Golden Age were growing restive and then being crushed by Knickerbockers, Special Constables, and Cossacks. During and after the war, they started to fight back in earnest.

Marx had predicted correctly, albeit prematurely, that laissez-faire capitalism would succumb to its internal contradictions, even as it grew stronger. And he had been proved right. The newly enfranchised working classes were organizing in unions and political parties—and where the right to organize legally was denied them, political oppression was inspiring revolutionary movements and anarchist bands. These movements were reinforced and ultimately led, again much as Marx had predicted, by middle-class intellectuals and anarchist romantics repulsed by the crass, inhuman materialism of their age. One of the characteristic media images of the golden period was the caped, black-hatted anarchist with a fizzing bomb under his arm. And this was not just media hysteria, as Keynes's description suggested, because the revolutionary groups of the 1880–1915 period far exceeded in their destructive political impact anything achieved in our age by the terrorists of the PLO, the IRA, or even Al-Qaeda.[11]

By 1914, the classical free-market capitalism of the Victorians was already declining. Never could it return to the happy complacency that Keynes described before World War I and the Russian Revolution. Never could it reverse the growing power of the working classes, the result of democracy and the steady expansion of voting rights.[12] The internal contradictions identified by Marx were moving inexorably toward a systemic breakdown, though how or when this crisis might happen was impossible to predict. In 1919, when Keynes was warning of the economic catastrophe foreshadowed by the Versailles Treaty, the danger was still invisible to less acute observers.[13]

It was not until the financial earthquakes of hyperinflation in Weimar Germany and the Great Depression of the 1930s that the rest of the world began to understand what Keynes was elegantly dissecting in his papers and what communist and fascist radicals had been shouting from the rooftops since 1918: The nineteenth-century politico-economic system was in its death throes. Capitalism had to reinvent itself or become extinct. The system opted for reform and survival.

The new species of capitalism born out of the economic disasters of the interwar period is what I call Capitalism 2. It can be dated from Britain's abandonment of the gold standard on September 21, 1931. It gained strength with Franklin Roosevelt's election as president in November 1932. Its intellectual symbol was Keynes's *General Theory*,[14] whose publication in 1936 crystalized the new economic and political ideas that were gaining influence

in the same way that *The Wealth of Nations* had codified the ideas of Capitalism 1 in 1776. And it grew to horrifying force as Hitler revived the German economy from 1933 onward with what can be seen with hindsight as the only wholehearted attempt to implement the policies that Keynes had been vainly recommending to the British government for the previous five years.[15]

This new species of capitalism thrived for roughly forty years and passed through the following four stages:

Capitalism 2.0: from 1931–38, the abandonment of gold and New Deal experimentation
Capitalism 2.1: from 1939–45, government-led militarism
Capitalism 2.2: from 1946–69, the Keynesian Golden Age
Capitalism 2.3: from 1970–80, inflation, the energy crisis, and the breakdown of the postwar gold-backed currency system

Of the many transformations that occurred in the 1930s, one of the most remarkable and historically resonant was the invention of a heroic government economist. Robert Skidelsky aptly subtitled the second volume of his magisterial biography of Keynes "The Economist as Hero." And soon there were odder juxtapositions: the heroic central banker and the heroic finance ministry bureaucrat. The newfound importance of government economic policy would have been inconceivable to anyone who lived just a few decades before. The interactions between the government and the market in Capitalism 1 had been considered incidental to economic activity and generally damaging to it: Governments needed to raise revenues through tariffs and taxes, mainly for fighting wars. Guilds, landowners, and manufacturers lobbied for tariffs to protect them from low-cost foreign competition. And artisans tried to sabotage factories and mass production. Governments chose sometimes to satisfy such special interests and other times to resist them, but that was the limit of economic politics.

Until the 1930s, almost no one, especially those in the nerve center of the global economy that was nineteenth-century Britain, believed that politicians could or should do anything to improve or stabilize the workings of the market. The cycles of finance and economic activity were treated as forces of nature, which politicians could no more moderate than they could influence the tides. Even the interventions of the Bank of England to quell panics in the money markets were seen mainly as private matters, motivated by the self-interests of the City of London and British finance, rather than a core responsibility of the state.[16] Prime Minister Gordon Brown has described in several speeches a document in the Treasury archives that shows the government's reaction to Keynes's early proposal to lift the British economy out of the Great Depression. His advocacy of what would now be described as demand management was dismissed by the permanent secretary of the Treasury in three scribbled words: *Extravagance, Inflation, Bankruptcy.*[17]

The view that government had no responsibility for macroeconomic conditions such as unemployment changed gradually after the First World War and was transformed by the collapse of global trade and industry in the early 1930s. As public outrage intensified over mass unemployment, the twin threats of socialist revolution and fascist dictatorship forced democratic politicians to engage with the economy in ways that classical economist had never imagined. At the same time, the breakdown of the gold standard suddenly offered governments a freedom of action never imaginable before. "Nobody told us we could do that" was how Sidney Webb, the founder of the London School of Economics and a prominent Labour politician, famously described the sudden sense of liberation for Ramsay MacDonald's government in Britain after its decision to abandon gold in September 1931.[18]

The upshot was that economists, politicians and voters gradually realized that markets and governments were enmeshed in ways that no one had previously understood. This realization led, in turn, to the defining characteristic of Capitalism 2: a belief that capitalism, if unguided by government, was ruinously and intrinsically unstable. Electing benign and competent governments to protect the public and the economy from the inevitable chaos of free markets thus became the most important function of politics, at least in peacetime.

The philosophy that the market was usually wrong, while the government was always right, reached its apotheosis in the Golden Age of Keynesian economics, from 1946 to 1969. This was the most successful period of economic management, in terms of living standards, technological progress, and financial stability, in the history of the world. But like the Edwardian Golden Age eulogized by Keynes in 1919, this "economic Eldorado" also came to an abrupt end.

From the late 1960s onward, the world was hit by a succession of economic crises. Arguably, these started with the inflationary financing of the Vietnam War and Great Society welfare spending under Lyndon Johnson, but other countries, including Britain, Italy, France, and even Germany, also faced severe disruptions, ranging from inflation to assassination and terrorism from the extreme Left and the extreme Right. The deathblows to Capitalism 2 were the breakdown of the international monetary system in 1971, when President Nixon unilaterally closed the U.S. Treasury's "gold window,"[19] and the 1973 Arab embargo, which quadrupled the price of oil. The result was a lethal combination of high inflation and mass unemployment that came to be known as *stagflation,* an economic malady the world had never seen before. By the time of the second oil shock, after the 1979 Iranian Revolution, capitalism faced the same dilemma as it did in the early 1930s: It had to transform itself or become extinct.

What emerged from the wreckage of stagflation was Capitalism 3. This period began with the election of Margaret Thatcher in June 1979, closely followed by Ronald Reagan's election in November 1980 and the taming of inflation by Paul Volcker's application of monetarism in 1981–82. The intellectual inspiration for this great transition came from Milton Friedman and his monetarist followers at the University of Chicago. Monetarism was closely related to other "new classical" economic doctrines, which revived the assumption that free, competitive markets, provided they were not distorted by state intervention, would always keep a capitalist economy in balance, producing efficient and rational outcomes, including economic stability and full employment.

According to modern economic orthodoxy, the fundamental cause of the great inflation of the 1970s was loose monetary policy, especially in America, as Presidents Johnson and Nixon printed money to finance the Vietnam War and the Great Society welfare programs. But many other countries, including Britain, Italy, Germany, and France, experienced even greater turmoil, ranging from inflation and labor unrest to student uprisings, cultural revolutions, and political assassinations, committed by both Left and Right. To explain the crisis of capitalism in the 1970s simply as a consequence of errors in monetary policy is therefore naïve. There were deeper reasons for the great inflation and the breakdown of state-led Keynesian capitalism than the financial profligacy of the U.S. and other governments. Conservative explanations of the breakdown stress the disincentive effects of high taxes, the stifling of private enterprise by overbearing governments, and the militant unions they empowered. Marxist accounts, ironically, emphasize some of the same factors, especially the class conflict and pressure for income redistribution promoted by an increasingly powerful labor movement. Indeed, the great inflation can be viewed more accurately as a symptom of the breakdown of Keynesian capitalism in the 1970s, rather than the cause. Economic theory today treats inflation as a purely monetary phenomenon, determined by the amount of money created by central banks. But there were deep political and sociological reasons why monetary expansion began to produce inflation in the late 1960s, instead of fueling rapid growth of employment and real output, as it had in the previous twenty years.

The Keynesian full-employment policies of the postwar period sowed the seeds of their own destruction. In an economic system built on natural tensions over the distribution of wages and profits between workers and capitalists, unemployment, or at least the fear of unemployment, has a crucial disciplining effect. By the late 1960s , a postwar generation of workers had grown up with no experience of mass unemployment and no memories of the Great Depression. As a result, labor militancy intensified and pay demands escalated; and in an economic system where the top priority of government policy was maintaining full employment, companies felt confident that enough money would be printed to accommodate whatever pay offers were needed to stave off labor militancy and strikes. Inflation was the inevitable result. The only way to stop this inflationary spiral and restore discipline in the labor market was for governments to abandon full-employment policies and create conditions in which millions of workers would lose their jobs. This is exactly what happened after 1979.

The self-destruction of Keynesian full-employment policies was anticipated in 1943, in one of the most prescient economic papers ever published. The Polish economist Michal Kalecki, who had collaborated with Keynes in Cambridge and Oxford in developing the policies that had solved capitalism's crisis of unemployment, argued that this solution would itself create a new crisis of capitalism, triggered by labor militancy and inflation. This inflationary crisis would, in turn, force the capitalist system to reinvent itself again—and economic theory would devise retrospective justifications for whatever new policies the survival of capitalism demanded:

> The assumption that a government will maintain full employment in a capitalist economy if it knows how to do it is fallacious . . . Under a regime of permanent full employment "the sack" would cease to play its role as a disciplinary measure. Continuous full employment would cause social and political changes which would give impetus to the opposition of business leaders . . . The self-assurance and class-consciousness of the working class would grow. Strikes for wage increases and improvements in working conditions would create political tension . . . Popular pressure for jobs would reach its height at or near election times, leading to government-induced preelection booms. The workers would get out of hand and the "captains of industry" would be anxious "to teach them a lesson" . . . A powerful bloc is likely to be formed between big business and *rentier* interests, and they would probably find more than one economist to declare that the situation was manifestly unsound.[20]

The economist found to "declare the situation manifestly unsound" was Milton Friedman. The transition from Capitalism 2 to Capitalism 3 proceeded almost exactly as Kalecki had foreseen. The Thatcher-Reagan political revolution was paralleled by the monetarist revolution in economic theory, and between them they overturned the faith in active government inspired by Keynes. Like the previous phases of capitalism, this new era could be roughly divided into several subperiods:

Capitalism 3.0: from 1979–83, early monetarism and confrontations with unions
Capitalism 3.1: from 1984–92, Volcker and Greenspan, Thatcher-Reagan booms
Capitalism 3.2: from 1992–2000, the Great Moderation
Capitalism 3.3: from 2001–08, market fundamentalism under Greenspan and George W. Bush

This thirty-year epoch started with Thatcherism in 1979 and ended with the crisis of 2007–09. As Capitalism 3 dies out, a new creature, related but distinct, could be seen emerging from the undergrowth and preparing to become the dominant species.

We will consider the characteristics that Capitalism 4 will need to develop to prosper in the new politico-economic landscape in Parts IV and V. But before turning to the development and survival of the new species, let us consider in detail the reasons for the extinction of the previously dominant species. This is the subject of Parts II and III.

Part II

The Arrow and the Ring

All great financial crises begin with the belief that the world has changed forever. They all end with the realization that the change was not what it seemed. A cliché among professional investors is that the four most expensive words in the English language are "This time it's different." But while it is dangerous to ignore the cyclical nature of financial markets, and of human behavior more generally, we must also recognize that the driving forces of economic and business activity—technologies, social structures, and political institutions—can and do change. It is a fashionable conceit, especially in the midst of crises, to claim that the secular trends of historical progress can have no permanent effects on the fundamentals of capitalism: the emotions of greed and fear, the balance between government and business, the speculative behavior of stock market investors, and so on. However, such cynicism is even more deluded than the faddish enthusiasm that imagines every new technological gadget to mark the dawn of a new age. In short, four words even more expensive and foolish than "This time it's different" are "Everything's always the same."

A proper understanding of the dynamics of capitalism requires us to recognize both the long-term trends that change the world and the financial cycles that sometimes exaggerate and overwhelm these secular trends. To put this more graphically, history and economics are driven by a rivalry between what can be called the arrow of progress and the ring of repetition. I choose these metaphors because the arrow and the ring are among the most pervasive symbols in the mythologies of any nation. Every civilization has understood the dualistic interplay between change and permanence, between the male and female principles, between the yang and yin of creativity and preservation. And this creative tension is as much a driving force in politics and economics as it is in every other aspect of human psychology.

Yet this all-important dualism of life and society is rarely mentioned in economic discussions. Instead of trying to understand the interplay between repetition and progress, economists and financiers are typically divided into two mutually hostile camps. Some declare that the lessons of

previous experience are irrelevant because the Internet or globalization or the credit-crunch has changed everything: Technology shares will rise to infinity; all the goods in the world will be made in China; credit will contract or expand forever. Others insist that all cycles are the same. The boom-bust cycle in housing was essentially the same as the speculation in technology stocks in the 1990s, the Japanese bubble in the 1980s, and Tulipmania in seventeenth-century Holland. But why should we adopt either of these extreme views?

Some features of human life do permanently change history, for example, the abolition of slavery, the invention of antibiotics, or the harnessing of electricity or computer power. Others, ranging from love and hate to financial panic, are repeated in every generation with uncanny precision. Only by thinking about *both* the arrow of progress and the ring of repetitive behavior can we understand how they interact to create the risks and opportunities of economic life.

In the specific case of the 2007–09 crisis, we can see how several genuinely unprecedented trends dating to the late 1980s coincided with a powerful, but not unusual, financial cycle. This overlay of cycle and trends produced a boom until 2006. This boom was followed by a cyclical bust that was amplified by a series of extraordinary policy blunders (described in Chapters 9 and 10) and led to the near-destruction of the world capitalist system in the autumn of 2008. Contrary to predictions, however, the system did not collapse, because the next phase of the cycle, again interacting with long-term uptrends that had been forgotten during the period of panic, created the conditions for a rebirth and evolution of capitalism in 2010 and beyond.

Because economics is driven by both secular trends and cyclical patterns, we need to start by looking at both sets of forces separately and then consider how they interact. Only in this way can we properly understand why recent events happened and where they may lead.

However, the underpinning of the post–World War II global economy has steadily eroded since the end of the Soviet threat. To ensure survival of the global economy, the United States and other major powers must recommit themselves to work together to rebuild its weakened political foundations.

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* CHAPTER ONE *

The Second Great Age of Capitalism

AMERICANS, other citizens of the industrialized world, and many peoples in other parts of the international economy have entered what the financial expert and economic commentator David D. Hale has called "the Second Great Age of Global Capitalism." The world economic and political system is experiencing its most profound transformation since emergence of the international economy in the seventeenth and eighteenth centuries. The end of the Cold War, the collapse of the Soviet Union, a stagnant yet enormously rich Japan, the reunification of Germany and its consequent return as the dominant power in Western Europe, and the rise of China and Pacific Asia are influencing almost every aspect of international affairs. Changes originating in earlier decades have also become more prominent; these developments include the technological revolution associated with the computer and the information economy and the redistribution of economic power from the industrialized West to the rapidly industrializing and crisis-riven economies of Pacific Asia. The worldwide shift to greater reliance on the market in the management of economic affairs, and what many call the "retreat of the state," are integrating national economies everywhere into a global economy of expanding trade and financial flows. However, it is the demographic revolution that will have the greatest long-term significance. The extraordinary population decline in the industrialized world and the explosive growth of population in China, India, other parts of Asia, and elsewhere in the developing world will continue to significantly alter the global distribution of economic and, of course, military power.

These developments are having important consequences for the lives of us all. There will be many winners as global capitalism refashions almost every aspect of domestic and international economic affairs. There will also be many losers, at least over the short term, as international competition intensifies and as businesses and workers lose the secure niches that they enjoyed in the past. Economic globalization presents both threats and challenges for the well-being of peoples everywhere. If individuals and societies are to adjust intelligently to the challenge of global capitalism, it is imperative that they understand the principal forces transforming international economic and political affairs.

The Triumph of Economic Liberalism

The end of the Cold War in 1989 and the collapse of the Soviet Union in 1991 sparked an international debate on the nature of the "new world order." After the disintegration of the Soviet empire in Eastern Europe and the subsequent fragmentation of the Soviet Union itself, speculation on the transformation of the international system and the nature of the post–Cold War era reached flood tide. When disappearance of the Communist threat left the United States as the only true superpower, many commentators believed that the American liberal values of democracy, individualism, and free markets had triumphed and that the world was on the verge of an era of unprecedented prosperity, democracy, and peace. Less sanguine observers countered that the bipolar stability of the postwar world was being supplanted by a chaotic, multipolar world of five or more major powers, a world characterized by new forms of intense ethnic, political, and economic conflict; indeed, some even expected that the world might one day look back with nostalgia to the simpler and more certain bipolar Cold War world that the historian John Lewis Gaddis had called the "long peace."[3]

Through most of the latter half of the twentieth century, the Cold War and its alliance structures provided the framework within which the world economy evolved; now that framework has been weakened. During the Cold War, the United States and its allies generally subordinated potential economic conflicts within the alliance to the interests of political and security cooperation. Their emphasis on security interests and alliance cohesion provided the political glue that held the world economy together and facilitated compromise on important economic differences. Even though the United States did, as many European and

Japanese charged, occasionally use its political leverage to exact economic concessions from its several alliance partners, the United States also clearly emphasized its security interests and allied cooperation more than its own narrow economic interests.

With the end of the Cold War, national priorities changed and the Western allies assigned a higher priority to their own national (and frequently parochial) economic interests. A shift in American policy had already become evident during the Reagan and Bush Administrations. The new, more nationalistic emphasis was carried further in the succeeding Clinton Administration; its declaration that *economic security* had displaced the earlier concern with *military security* made the change crystal clear.[4] Proponents of "geo-economics" argued that economic conflict had displaced traditional security and political interests.[5] A change in American attitudes and priorities appeared in growing economic unilateralism and in ratification of the North American Free Trade Agreement. Another significant manifestation of this change was the pursuit in the early 1990s of an aggressive managed trade or "results-oriented" trade policy toward Japan.

The priorities of Western Europe and Japan also changed in the 1990s. Both became less willing to follow American leadership, much less tolerant of America's disregard of their economic and political interests, and more likely to emphasize their own national priorities. Reunified Germany assigned greater importance to European regional issues and less to its alliance with the United States and began to lead in creation of an economically and politically united Europe. Japan rediscovered its "Asianness" and gave growing emphasis to the development of an integrated Pacific Asian regional economy under Japanese leadership. During the 1990s, regional concerns began to take precedence over North American, trans-Atlantic, and trans-Pacific issues.

These shifts in national priorities and foreign policies have extraordinarily important ramifications for the future of the world economy. Since World War II, the principal foundations of the international economy with its free markets and trade liberalization have been America's international leadership and the willingness of Western Europe and Japan to follow America's lead. However, in the 1990s, the most prosperous and economically successful era in world history was threatened by changes. The close cooperation of previous decades had weakened, and there could be serious negative consequences for world peace and prosperity. The global economic turmoil of the century's final years warns that there are serious threats to the health and stability of a liberal global economy.

The Achilles heel of the post–Cold War liberal world order is the poor public understanding of economic liberalism, of the functioning of the market system, and of how capitalism creates wealth. The acrimonious debate over the North American Free Trade Agreement (NAFTA), for example, revealed that many American citizens and even some very successful business executives failed to comprehend the rationale for trade liberalization. Economists' arguments that open markets are very beneficial and that trade protection can be very costly are frequently overwhelmed by popular misconceptions and self-serving demands for protection against "cheap" imports and "unfair" trading partners.

Economists themselves must assume part of the responsibility for public misunderstanding. Too many American economists are content to continue writing their frequently incomprehensible technical papers and to remain aloof from public discussions of crucial issues of economic policy. A notable exception to this detached attitude is found in *Globaphobia* (1998), where Gary Burtless and his colleagues use conventional economic analysis in a comprehensible manner to dispel strident and unfounded attacks on globalization.[6] Without a better understanding by the average citizen of how the market economy works, including its strengths and its weaknesses, the liberal economic order will continue in jeopardy.

Economic Globalization

Since the early 1980s, economic issues and the global economy have become more central to international economic and political affairs than at any time since the late nineteenth century. Many commentators have noted a profound shift from a state-dominated to a market-dominated world. The market's increased importance, reflected in increased international flows of goods, capital, and services, has been encouraged by declining costs of transportation and communications,

the collapse of command-type economies, and the increasing influence of a conservative economic ideology based on the policy prescriptions of economics. This resurgence of the market is really a return to the pre–World War I era of expanding globalization of markets, production, and finance.

At the turn of the century, issues arising from economic globalization confront national societies and the international community. Immediately after the end of the Cold War almost every economist, business executive, and political leader in both industrialized and industrializing countries expected that economic globalization would lead to a world characterized by open and prosperous economies, political democracy, and international cooperation. However, as the 1990s progressed, and especially in response to the post-1997 global economic turmoil, a powerful negative reaction to globalization arose in both developed and less developed countries. Rejections of globalization and its alleged negative consequences became especially strident within the United States, Western Europe, and some industrializing economies. Globalization has been blamed for everything from growing income inequality to chronic high levels of unemployment and even to the oppression of women, and critics have favored such nostrums as trade protectionism, closed regional arrangements, and severe restrictions on migration. Certainly the future of the international economic and political system will be strongly affected by the relative success or failure of the proponents and opponents of globalization.

According to the "globalization thesis," a quantum change in human affairs has taken place as the flow of large quantities of trade, investment, and technologies across national borders has expanded from a trickle to a flood. Political, economic, and social activities are becoming worldwide in scope, and interactions among states and societies on many fronts have increased. As integrative processes widen and deepen globally, some believe that markets have become, or are becoming, the most important mechanism determining both domestic and international affairs. In a highly integrated global economy, the nation-state, according to some, has become anachronistic and is in retreat. A global capitalist economy characterized by unrestricted trade, investment flows, and the international activities of multinational firms will benefit rich and poor alike.

Others, however, emphasize the alleged downside of economic globalization, including the increase of income inequality both among and within nations, high chronic levels of unemployment in Western Europe and elsewhere, and, most of all, the devastating consequences of unregulated financial flows. These critics charge that national societies are being integrated into a global economic system and buffeted by economic and technological forces over which they have very little control. For them, the global economic problems of the late 1990s offer proof that the costs of globalization are much greater than its benefits.

Although the term "globalization" is now used broadly, economic globalization has entailed just a few key developments in trade, finance, and foreign direct investment by multinational corporations. Since the end of World War II, *international trade* has greatly expanded and has become a much more important factor in both domestic and international economic affairs. Whereas the volume of international commerce had grown by only 0.5 percent annually between 1913 and 1948, it grew at an annual rate of 7 percent from 1948 to 1973.[7] As figure 1.1 shows, international trade has grown much more rapidly than the global economic output. Over the course of the postwar era, trade has grown from 7 percent to 21 percent of total world income. The value of world trade has increased from $57 billion in 1947 to $6 trillion in the 1990s. In addition to the great expansion of merchandise trade (goods), trade in services (banking, information, etc.) has significantly increased during recent decades. With this immense expansion of world trade, international competition has greatly increased. Although consumers and export sectors within individual nations benefit from increased openness, many businesses find themselves competing against foreign firms that have greatly improved their efficiency. During the 1990s, trade competition became even more intense as a growing number of industrializing economies shifted from an import-substitution to an export-led growth strategy. Nevertheless, the major competitors for most all American firms are other American firms.

Underlying the expansion of global trade have been a number of developments. Since World War II, trade barriers have declined significantly due to successive rounds of trade negotiations.[8] For example, over the past half century, average tariff levels of the United States and other industrialized countries on imported products have dropped

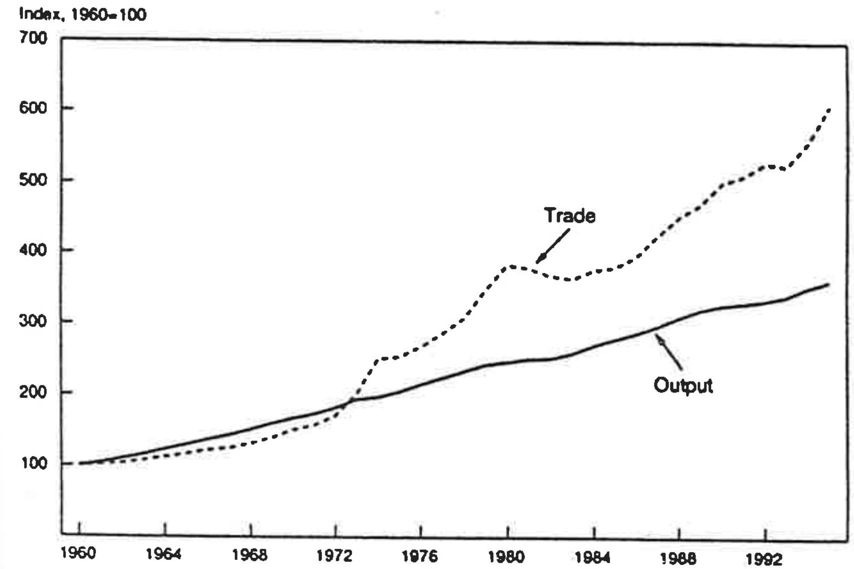

Fig. 1.1. Growth in World Output and Trade. Trade has expanded much faster than output, especially since the early 1970s.
Source: U.S. Council of Economic Advisors.

from about 40 percent to only 6 percent, and barriers to trade in services have also been lowered. In addition, since the late 1970s deregulation and privatization have further opened national economies to imports. Technological advances in communications and transportation have reduced costs and thus significantly encouraged trade expansion. Taking advantage of these economic and technological changes, more and more businesses have expanded their horizons to include international markets. Despite these developments, most trade takes place among the three advanced industrialized economies—the United States, Western Europe, and Japan, plus a few emerging markets in East Asia, Latin America, and elsewhere. Most of the less developed world is excluded, except as exporters of food and raw materials. It is estimated, for example, that Africa south of the Sahara accounted for only about 1 percent of total world trade in the 1990s.

Since the mid-1970s, the removal of capital controls, the creation of new financial instruments, and technological advances in communications have contributed to a much more highly integrated *international* *financial system*. The volume of foreign exchange trading (buying and selling national currencies) in the late 1990s has been approximately \$1.5 trillion per day, an eightfold increase since 1986; by contrast, the global volume of exports (goods and services) for all of 1997 was \$6.6 trillion, or \$25 billion per day! In addition, the amount of investment capital seeking higher returns has grown enormously; by the mid-1990s, mutual funds, pension funds, and the like totaled \$20 trillion, ten times the 1980 figure. Moreover, the significance of these huge investments is greatly magnified by the fact that foreign investments are increasingly leveraged; that is, they are investments made with borrowed funds. Finally, derivatives or repackaged securities and other financial assets play an important role in international finance. Valued at \$360 trillion (larger than the value of the entire global economy), they have contributed to the complexity and to the instability of international finance. It is obvious that international finance has a profound impact on the global economy.

This financial revolution has linked national economies closely to one another, significantly increased the capital available for developing countries, and, in the case of the East Asian emerging markets, accelerated economic development. However, as a large portion of these financial flows is short-term, highly volatile, and speculative, international finance has become the most vulnerable and unstable aspect of the global capitalist economy. The immense scale, velocity, and speculative nature of financial movements across national borders have made governments more vulnerable to sudden shifts in these movements. Governments can therefore easily fall prey to currency speculators, as happened in the 1992 European financial crisis (which caused Great Britain to withdraw from the Exchange Rate Mechanism), in the 1994–1995 punishing collapse of the Mexican peso, and in the devastating East Asian financial crisis in the late 1990s. Whereas for some, financial globalization exemplifies the healthy and beneficial triumph of global capitalism, for others the international financial system seems "out of control" and in need of improved regulation.

The term "globalization" came into popular usage in the second half of the 1980s in connection with the huge surge of foreign direct investment (FDI) by multinational corporations (MNCs). As shown in figure 1.2, FDI expanded significantly in the late 1980s, increasing much

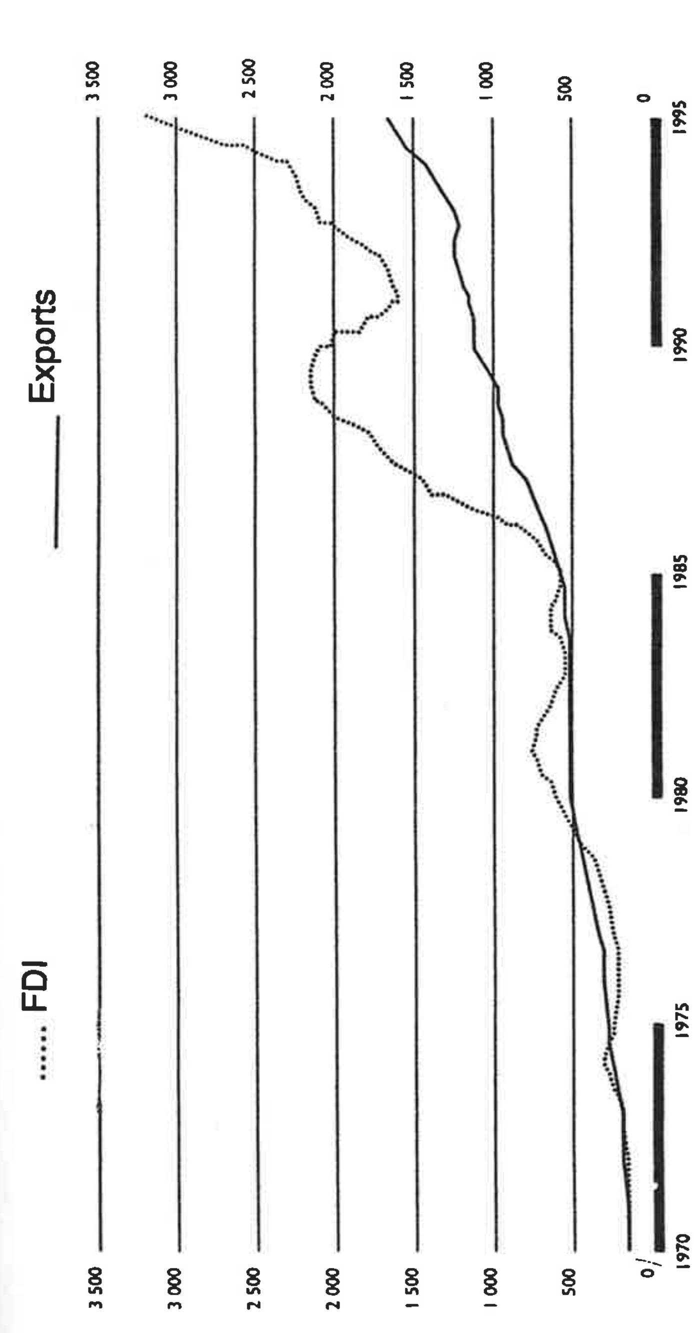

Fig. 1.2. Globalization Trends: Trade and Investment Flows (1970 = 100).
Source: Organization of Economic Cooperation and Development (OECD).

more rapidly than world trade and economic output. Throughout much of the 1990s, FDI outflows from the major industrialized countries to industrializing countries rose at approximately 15 percent annually; FDI flows among the industrialized countries themselves rose at about the same rate. In the late 1990s, the cumulative value of FDI amounts to hundreds of billions of dollars. The greatest portion of this investment has been in high-tech industries, such as those of automobiles and information technology.

These general statements, however, hide noteworthy aspects of FDI and MNC activities. Despite much talk of corporate globalization, FDI is actually highly concentrated and distributed very unevenly around the globe. Most FDI takes place in the United States, China, and Western Europe because firms are attracted to large or potentially large markets. FDI in less developed countries, with a few notable exceptions, has been modest. In addition to that in a few Latin American countries, and particularly in the Brazilian and Mexican automobile sectors, most FDI in developing countries has been placed in the emerging markets of East and Southeast Asia, particularly in China. When one speaks of corporate globalization, only a few countries are actually involved.

Despite the limited nature of corporate globalization, multinational corporations (MNCs) and FDI are very important features of the global economy. The increasing importance of MNCs has profoundly altered the structure and functioning of the global economy. These giant firms and their global strategies have become major determinants of trade flows and of the location of industries and other economic activities around the world. Most investment is in capital-intensive and technology-intensive sectors. These firms have become central in the expansion of technology flows to both industrialized and industrializing economies. As a consequence, multinational firms have become extremely important in determining the economic, political, and social welfare of many nations. Controlling much of the world's investment capital, technology, and access to global markets, such firms have become major players not only in international economic, but in political affairs as well, and this has triggered a backlash in many countries.

Economic globalization has been driven by political, economic, and technological developments. The compression of time and space by advances in communications and transportation has greatly reduced

the costs of international commerce while, largely under American leadership, both the industrialized and industrializing economies have taken a number of initiatives to lower trade and investment barriers. Eight rounds of multilateral trade negotiations under the General Agreement on Tariffs and Trade (GATT), the principal forum for trade liberalization, have significantly decreased trade barriers. Since the mid-1980s, Latin American, Pacific Asian, and other developing countries have initiated important reforms to reduce their trade, financial, and other economic barriers. More and more firms have pursued global economic strategies to take advantage of these developments.

Elimination of capital controls and movement toward a global financial system along with removal of barriers to FDI have also accelerated the movement toward both global and regional integration of services and manufacturing. In both industrialized and industrializing economies, spreading pro-market thinking has strongly influenced economic policy to reduce the role of the state in the economy. The collapse of the Soviet command economy, the failure of the Third World's import-substitution strategy, and the growing belief in the United States and other industrialized economies that the welfare state has become a major obstacle to economic growth and to international competitiveness have encouraged acceptance of unrestricted markets as the solution to the economic ills of modern society. Sweeping reforms have led to deregulation, privatization, and open national economies. In the late 1990s, the debate over the costs and benefits of economic globalization became highly acrimonious.

Meanwhile, the increased openness of national economies, the enlarged number of exporters of manufactured goods, the more rapid increase in trade than in the growth of the global economic product, and the internationalization of services have greatly intensified international economic competition. Growth of the proportion of world output traded on international markets has been accompanied by a significant change in the pattern of world trade. Many less developed countries (LDCs) have shifted from exporting food and commodities to exporting manufactured goods and even services. As indicated in figure 1.3, since 1965 the developing economies' share of world trade has increased considerably. Manufactured goods have begun to provide a growing proportion of this LDC trade at the same time that the United States and

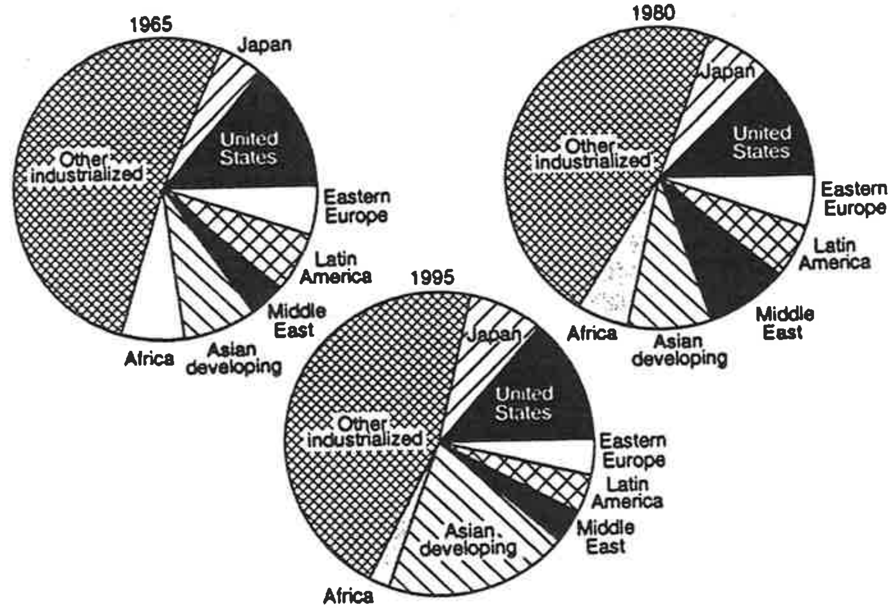

Fig. 1.3. Shares of World Trade. The share of Asian developing countries in international trade has risen greatly since 1980, increasing the overall importance of developing countries in world trade. *Note*: Eastern Europe includes the (former) USSR. *Source*: U.S. Council of Economic Advisors.

other advanced industrial economies have been shifting from manufactured exports to export of services. This restructuring of the entire global economy is economically costly and politically difficult and is producing many losers as well as winners.

Intensification of global competition in manufacturing, especially in high-tech products, has resulted in increased concern in advanced economies about international competitiveness, particularly about manufactures from the low-wage industrializing countries. The prestigious World Economic Forum reflected these concerns when it proclaimed in the mid-1990s that competition from industrializing countries was causing deindustrialization of the advanced economies. These concerns have been magnified as more and more Pacific Asian countries have sought to export their way out of economic distress; consequently, more and more groups and leaders in advanced economies worry about such competition and brand it as unfair. Some even express fear that their own living standards could be reduced to those of China. Many

believe that intensified competition from the industrializing countries has, at the least, increased job insecurity, unemployment, and income inequality; growing concerns have increased pressures for trade protection and economic regionalism.

The increased openness of the world economy, emergence of new industrial powers, and the global economic slowdown have contributed to a substantial surplus productive capacity in a number of industrial sectors. A notable example is automobile manufacture, which, like possession of a national airline, has long been considered a necessary attribute of a sovereign nation as well as a source of high wages for blue-collar workers. The United States, Japan, many European countries, and some industrializing countries have large automotive industries. It is obvious that many of these firms must merge or even eventually shut down as the global supply of automobiles outruns effective demand; of the approximately eighteen major auto firms in the world, it is probable that only about seven or so will ultimately survive.

Global overcapacity in a number of economic sectors has caused some observers to declare that the world economy is suffering from a glut of manufactured goods, or what Marxists call "underconsumption"; this has led many observers to declare that global capitalism is in a systemic crisis requiring radical structural reforms.[9] Certainly, rationalization along with elimination of surplus capacity in the automobile and many other economic sectors has been made necessary by globalization. Adjustment will be painful and will result in large numbers of laid-off workers, especially low- or semi-skilled workers, who may find it difficult to find equally well paying jobs. However, as Paul Krugman has argued, a large part of the "surplus" problem is due to the exaggerated fear of inflation in such countries as Japan and Germany where central banks place a higher priority on price stability than on economic growth.[10] More expansionary economic policies would significantly reduce the surplus. Moreover, as has happened in the past, the problem of excess capacity in certain sectors will work itself out as supply is reduced to match demand. But until the problem is resolved, it will pose severe political problems for national governments and for the world economy.

Although there is general agreement on the increased importance of the market and of globalization, there is intense controversy over the role of economic factors in the determination of international economic affairs and over the likelihood of cooperation versus conflict. Oversimplifying somewhat, two schools of thought on this issue can be discerned in American and other writing. I shall call one school the "market-oriented" position because of its emphasis on free markets and its commitment to free trade and, most important, to a significant decrease in the role of the state in the economy. The other school of thought is more diverse, but, for lack of a better term, I shall call it the "revisionist" position because of its emphasis on economic conflict, trade protection, and the strong role of the state in the economy.[11]

The market-oriented position is based on the theories and policy prescriptions of economics and asserts that, whereas in the recent past the policies of powerful states and international institutions have played the dominant role in the organization and functioning of the international economy, in the twenty-first century free markets and economic forces will increasingly determine international economic affairs. The demise of communism, the increasing integration of national markets, and the failure of inward-looking economic policies of less developed countries have resulted in a global shift toward such market-oriented policies as free trade and export-led growth and to a drastic reduction of the role of the state in the economy. As the London *Economist* has observed, since the collapse of communism, there has been universal agreement that no serious alternative to free-market capitalism exists as the way to organize economic affairs.

Positive view

Many also argue that the world is moving toward a politically borderless and highly interdependent global economy that will foster prosperity, international cooperation, and world peace. In this view, with the triumphal return to the free market and the laissez-faire ideals of the nineteenth century, global corporations will lead in organizing international production and maximizing global wealth. A corollary of this position is that the American economic and political system ~~has be-~~ ~~come~~ the model for ~~the world.~~ Moreover, the United States, as the only true superpower, will lead the rest of the world. Global economic policy ~~will focus on e~~conomic multilateralism and on strengthening international rules and institutions created within the Bretton Woods system. American leadership and the reformed Bretton Woods system will facilitate continued cooperation among the dominant economic powers and thereby ensure the global economy's smooth functioning.

neg Vi

Revisionist critics of globalization foresee a world characterized by intense economic conflict at both the domestic and international levels. Believing that an open world economy will inevitably produce more losers than winners, revisionists argue that unleashing market and other economic forces could result in an immense struggle among individual nations, economic classes, and powerful groups. Geo-economic adherents of this position believe (paraphrasing the German strategist Karl von Clausewitz) that international economic competition, especially in manufacturing, is the pursuit of foreign policy by other means. Many assert that this global struggle for market share and technological supremacy will be embodied in competing regional blocs dominated by one or another of the three major economic powers and that the European Union under German leadership, the North American bloc under U.S. leadership, and the Asian Pacific bloc under Japanese leadership will vie for economic and political ascendancy.

This rather pessimistic position declares that the clash between communism and capitalism has been replaced by conflict among rival forms of capitalism and social systems represented in regional economic blocs. In a provocative article in 1991, for example, Samuel P. Huntington argued that, with the end of the Cold War, Japan had become a "security threat" to the United States.[12] Subsequently, in even more provocative writings, Huntington proclaimed that intracivilizational conflicts will dominate the agenda of world politics well into the twenty-first century.[13] Some commentators, reflecting on the tragic events in the former Yugoslavia and in the Soviet Union in the 1990s, argue that an age of intense ethnic and nationalistic conflict has been unleashed on the world. In a world still divided by rival national ambitions in which economic factors in effect determine the fate of nations, many conclude that international economic affairs will become increasingly filled with conflict.

Technology, the Information Economy, and Services

The end of the Cold War and economic globalization have coincided with a new industrial revolution. The computer and the rise of the information or Internet or knowledge economy are transforming almost every aspect of economic, political, and social affairs. Some analysts even argue that recognition by Soviet leaders that the Soviet Union was falling behind Japan and the West in such technologies was an indirect cause of their fateful decision to reform the lagging Soviet economy. Acknowledging the importance of the information economy, a number of scholars have set forth ambitious theories predicting the trajectory of social affairs in the century ahead.[14] While these theories provide some interesting insights, the long-term consequences of the computer and the information economy will be unclear for many decades to come.

Most observers believe that the information economy and computing power have been giving an impetus to the world economy similar to that produced by steam power, electric power, and oil power in the past. Since the mid-eighteenth century, as the stimulus provided by one industrial transformation has been exhausted, another technological revolution has moved the world economy to a new level. As the Industrial Revolution based on steam power lost its momentum in the last decades of the nineteenth century, steam was replaced by oil and electric power. The impetus provided by the oil age waned in the final decades of the twentieth century, and the rate of economic and productivity growth declined, especially in the United States and Western Europe. With the transition of these economies from the oil age to the information age, some argue that this recent shift has created a new economic model based on the computer, economic globalization, and corporate restructuring, and that this underlies the outstanding success of the American economy in the 1990s.

The economics profession is deeply divided about whether or not computer power represents a technological revolution on the same scale as steam, oil, and electric power. Some economists point out that it is difficult to find convincing evidence that the computer has significantly accelerated the rate of economic and productivity growth. They also argue that computing power has not transformed the overall economy on the same scale that steam or electric power transformed every aspect of economic and social affairs. Despite heavy investment in computers and associated technologies, computers and peripherals still represent a very small percentage of net nonresidential fixed capital. A growing number of other economists, however, believe that investments in computers and information technologies are beginning to

have an important impact on productivity and on economic affairs in general. In support of this position, economic historian Paul David has pointed out that the long-term impact of the computer and information economy cannot be determined with any precision until well into the twenty-first century. After all, as David reminds us, it took nearly forty years, from the early 1880s to the 1920s, for the commercialization of electricity to affect economic growth and social change to a measurable degree. Resolution of this issue is also extremely hard to attain because it is very difficult to measure productivity growth, especially in the service industries that now comprise 70 percent of the American economy.

If the information economy does not result in significant increases in productivity, it is unlikely that there will be continued high and sustained increases in the rates of economic development in the advanced industrial countries. In the United States, the relatively low increases in productivity after the early 1970s resulted in stagnant wages. There has been considerable debate about whether or not a significant increase in the overall rate of American productivity growth did occur even in the 1990s. In Western Europe, a slowdown in the rate of productivity has contributed to sluggish economies. Such conditions on both sides of the Atlantic have fed the forces of trade protectionism and encouraged many to believe that the computer and the information economy are the cause of, rather than the solution to, their economic troubles. This fear has been compounded by growing concerns over competition from Pacific Asian economies with huge low-paid and disciplined workforces. Many blue- and white-collar workers in the West believe that they are caught between decreased demand for their labor because of the wide use of the computer and an increased supply of workers worldwide because of the entry of China and other East Asian economies into the world economy.

Whether or not there has been a true technological revolution based on computing power, technological changes are having a significant impact on the world economy; the following changes are particularly important:[15]

1. *Increased Rate of Technological Innovation*. There has been a flood of new scientific and technological developments in a wide number of fields such as biotechnology, microelectronics, telecommunications,

and new materials. More new knowledge has been produced over the last thirty years than in the previous five thousand. Certain factors appear to be particularly responsible for the acceleration in technological development. Significant advances in basic science and the greatly reduced cost of knowledge manipulation due to the use of computers are important contributing factors. The cost of storing and transmitting knowledge fell at the rate of about 20 percent a year for forty years; the decline in energy costs associated with the Industrial Revolution was only 50 percent during a thirty-year period. Intensified international competition among the major powers has stimulated scientific and technological innovation, and acceleration in the rate of technological change has made technology the most crucial factor in economic growth and international competitiveness.

2. *Broad Applicability of New Technologies.* Newer technologies, especially in computing and electronics, are relevant to a broad array of economic processes and other activities in many sectors of the economy. Process control, automation, and automatic data processing are revolutionizing both manufacturing and services in every industrial economy; and in all these areas, demand for low-skilled and unskilled labor has decreased.

3. *Shortened Process and Product Life Cycles.* The technological life cycles of both products and production processes have been dramatically shortened; that is, less time elapses between innovation of a new process or product, commercialization of that product, and diffusion of the technology to competitors both at home and abroad. This compression of time, in turn, has led to greater internationalization of technological developments and to such new competitive strategies as expanded strategic and technological alliances among the multinational corporations of many countries.

While technological developments obviously have implications for domestic and international economic affairs, both the nature and the importance of these implications are extremely controversial. Some critics of technology charge that rapid technological advance is having a devastating impact on the highly industrialized countries. Some "neo-Luddites" charge that the speed of contemporary technological ad-

vances will lead to massive technological unemployment and "the end of work." Most American economists, on the other hand, in response to these fears, argue that they are based on the faulty idea that if the jobs in an economy are taken over by machines, there will be fewer jobs for human beings. Economists proclaim, to the contrary, that technological progress has meant and will mean new and better jobs for everyone.

Closely associated with the rise of the information economy and a cause for fear of massive technological unemployment is the dramatic and accelerating shift from manufacturing to services (financial, software, retailing, etc.). This major transformation has been occurring as manufacturing employment has dropped and the share of services in the economy has rapidly increased; a similar change in employment took place in the late nineteenth century with the shift from an agricultural- to an industrial-based economy. Whereas the manufacturing sector accounted for 27 percent of American GNP in 1960, by 1998 its share had dropped to 15 percent of GNP. This change does not necessarily entail "deindustrialization" of the economy but rather means that the same volume of manufactured goods can be produced with a smaller and more productive workforce. The United States and Canada have taken the lead in this changeover from a manufacturing to a service economy, with nearly three-quarters of their workforces in services at the end of the century; Japan and Germany lag far behind. In the United States, the corporate "downsizing" and "reengineering" that began in the 1980s was at least in part a consequence of this momentous change.

The shift from a manufacturing to a service economy has been a wrenching experience for the United States; it is likely to be more so for Japan and Western Europe because of their economic and institutional rigidities. Although many critics in the late 1980s denounced the service economy as one of "hamburger flippers," this characterization is a distortion. Nevertheless, the ongoing switch to services has greatly increased job insecurity among many Americans, and many are losing high-paying assembly-line or middle-management positions. Such developments have been fragmenting the American workforce and will do the same in other industrialized economies. On the other hand, the rise of the service economy, propelled largely by the information revolution, has increased the demand for and raised the wage premium on education and skills while decreasing the demand for and the income of low-skilled and unskilled workers. Whether one works with or does not work with a computer has become the most important determinant of one's wages. A corollary is that the United States and the other industrialized economies are importing and will continue to import more and more manufactured goods from the low-wage industrializing economies of East Asia and elsewhere. And even though the United States has a huge trade surplus in services, its increased importing of manufactured goods has given rise to a highly emotional controversy over the impact of globalization on the welfare of American labor.

The Global Shift in Economic Power

Also important in the transformation of the world economy has been the redistribution of world industry away from the older industrialized economies—the United States, Western Europe, and, to a lesser extent, Japan—toward Pacific Asia, Latin America, and other industrializing economies. Although these emerging markets have been in very serious economic trouble since 1997, their economic "fundamentals," especially in East Asia, are sound; they possess high savings and investment rates as well as excellent workforces and will one day recover. Although the United States and the other industrialized economies still possess a preponderant share of global wealth and industry, they have declined in relative (not absolute) terms while the industrializing economies, especially China, have gained in economic importance over the course of the postwar period. The impact of the Pacific Asian economic crisis on the larger global economy provides strong evidence of the magnitude of the change that has taken place.

In the decades immediately following World War II, political leaders and intellectuals in the less developed countries (LDCs) denounced the capitalist developed countries as "imperialist" and "exploitative." Dependency theory blamed the poverty and underdevelopment of the LDCs on the policies of the dominant capitalist economies and on multinational corporations. In an effort to break away from dependence on the developed countries, many LDCs, especially in Latin America, closed their markets to the outside world and pursued nationalist import-substitution strategies in order to become self-sufficient. Their efforts to overturn the developed countries' control of the world economy climaxed in the mid-1970s with the unsuccessful effort of an LDC coalition to establish a New International Economic Order (NIEO). By the 1980s, this effort had failed; a significant number of LDCs had become heavily burdened by huge debts, their governments were running unmanageable budget deficits, and their economies suffered from high inflation rates that discouraged productive economic activities and foreign investment.

By the early 1990s, however, the situation of a number of LDCs had again changed dramatically. The debt crisis of most of these nations had eased. Many had deemphasized the import-substitution strategy while implementing sweeping structural adjustment policies to reform and strengthen their economies. Market-oriented reforms included pursuit of sound fiscal policies, deregulation, and a drastic reduction of the role of the state in the economy. Following the example of the emerging markets of Pacific Asia, other nations began to open their economies to the outside world and to pursue export-led growth strategies. Their changing economic fortunes caused disintegration of the LDCs' former political unity into regional groupings such as the Association of South East Asian Nations (ASEAN) and alliances based on economic interests such as the Cairns group of agricultural exporters.[16] Most LDCs, however, have failed to reform and adjust to the changing global economy.

Beginning in the late 1960s, as revealed by figure 1.4, the Four Tigers of East Asia (Hong Kong, Singapore, South Korea, and Taiwan), growing by 6 percent annually, outpaced the rest of the world. Other East and Southeast Asian countries such as Malaysia, Thailand, and Indonesia also have grown rapidly. The most significant change in the international balance of economic power has been the industrialization of Pacific Asia and especially of China, which, depending upon the measurement used, has become the world's second- or third-largest economy. A number of the Pacific Asian industrializing economies have developed and are developing automobile, electronics, and other advanced industries (in such areas as steel and chemicals) that have become highly competitive in world markets.

Although there is argument about the geographic boundaries of the region, it is clear that a distinct Pacific Asian economy, including North-

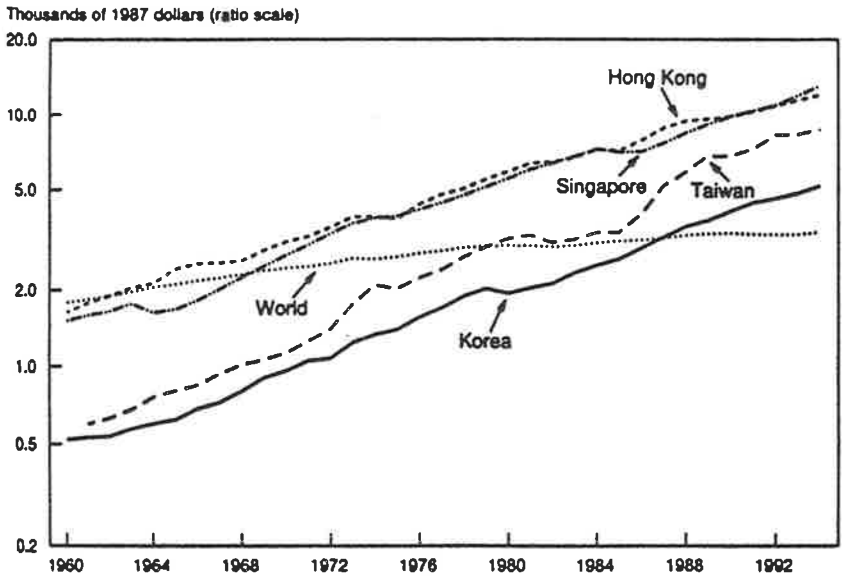

Fig. 1.4. GDP per Capita in the "Four Tigers." Since 1960, real GDP in each of the "four tigers" has grown by more than 6 percent per year.
Source: U.S. Council of Economic Advisors.

east Asia, Southeast Asia, and southern China, began to take shape in the late 1980s when this vast region became the most economically dynamic area in the world and important exporters of industrial and high-tech products. Until the 1997 financial crisis, Pacific Asia's economic success was indeed impressive. During the thirty years prior to the East Asian financial crisis, per capita income levels had increased tenfold in South Korea, fivefold in Thailand, and fourfold in Malaysia. Per capita income in Hong Kong and Singapore exceeded that of some Western industrialized countries.

In the 1980s and early 1990s, China experienced a rapid rate of economic growth and industrialization and became the most important member of the group of rapidly industrializing economies. The increasingly intertwined economies of mainland China, Hong Kong, and Taiwan (i.e., "Greater China") have become an important economic force in the region. Prior to 1850, China and India were the largest economies in the world, and at its current rate of economic growth China will most likely reoccupy that preeminent position some time in the twenty-

first century. If this prediction is fulfilled, other nations in the region and around the world will have to make huge adjustments to such a shift in economic power. It is equally or more significant that Chinese military capabilities have been expanding, and that, with the declining military importance of Russia in East Asia, China has emerged as a powerful and unpredictable economic and military power. Whether or not China can continue its rapid growth and the choices it makes as it exercises its expanding economic and military power are critically important to East Asia in particular, but also to the world in general.

The relationship of Pacific Asia and the West, principally the United States and Western Europe, is an important and contentious issue facing the international community. For many Western business and political leaders, the economic rise and increasing affluence of East Asia represent an unprecedented economic opportunity. As Western businesses contemplate this huge and growing market, one is reminded of the late-nineteenth-century quip that, if every "Chinaman" lengthened his garment by one inch, the mills of Manchester (England) would boom forever. For those critical of the increasing globalization of the world, the industrialization of Pacific Asia and other developing economies threatens a "Chineseization" of Western living standards. Many Americans and Europeans believe that competition from hundreds of millions of low-wage Chinese, Indian, and Mexican workers has been forcing down American wages and causing unemployment in Western Europe. This is reminiscent of Kaiser Wilhelm's evoking of the "Yellow Peril." However, it is not inevitable that either the optimistic scenario or the dire predictions be realized.

Although most economists dismiss the fears and point out that similar shifts have taken place in the past without unduly harming more-developed economies, opponents of globalization fear that several unique and very disturbing features of the industrial rise of Pacific Asia and other developing economies have made this situation particularly threatening: (1) By historic standards, the diffusion of industry from industrialized to industrializing economies has occurred very rapidly. Moreover, not only are traditional industries migrating to the industrializing economies, but many of the advanced technologies (e.g., electronics and other technologically sophisticated industries) on which the economic fortunes of the West have become dependent are moving southward and are intensifying competition. (2) Technological advances in transportation and communication have facilitated transfer of manufacturing techniques from the industrialized to the industrializing economies. The role played by Western and Japanese multinational firms has been a major point of contention in the United States, Western Europe, and even Japan; critics charge that the global strategies of these firms have accelerated diffusion of sophisticated technologies as the firms have attempted to increase their international competitiveness by combining the cheap labor of the South with the most advanced manufacturing techniques of the North. (3) The challenge posed to the older industrialized economies by this shift in manufacturing has been aggravated by the sheer magnitude of the problem. With the end of the Cold War and the increasing integration of the world economy, literally billions of low-wage workers have suddenly entered the world labor pool. Nothing of similar magnitude has ever happened previously. These workers are even willing to forgo the costly welfare benefits and health standards that Western workers demand.

Rather than accepting the "decline of the West" and "clash of civilizations" pessimism, most American economists reject the revived "yellow peril" thesis. Indeed, in a provocative article, Paul Krugman has generally dismissed the idea that the industrial rise of Pacific Asia poses a threat to the West.[17] The economic success of these economies has been due to the rapid mobilization of capital and labor and does not represent a significant increase in national productivity levels. The failure of these economies to raise their levels of productivity significantly, he wrote, means that their economic success is a one-time event (like that of the Soviet Union following World War II). As these economies exhaust available labor and capital, their economic growth will slacken. On the other hand, Krugman concedes that China's huge labor supply should produce a high rate of economic growth for many decades.

The extraordinarily rapid industrialization of Pacific Asia and the sudden emergence of many nations as important exporters has forced the modern world economy to confront, for the fifth time, problems caused by a sizable redistribution in the international balance of economic power and competitiveness. Earlier examples were the sudden emergence of Great Britain in the early nineteenth century following the Industrial Revolution and the Napoleonic Wars; the equally sudden

emergence of unified Germany, and subsequently of the United States, as major industrial export economies in the late nineteenth and early twentieth centuries; and Japan's unprecedented export expansion in the 1970s and the 1980s. With such profound shifts in economic power and international competitiveness, economic and political tension intensifies considerably; there is a search for scapegoats, and charges of "unfair trade practices" are issued. At the close of the twentieth century, the economic rise of China and other Pacific Asian economies has reproduced this familiar pattern.

The Demographic Revolution

Over the long term, the most important development transforming the world economy can be described as a demographic revolution in which two separate developments are altering population distribution in the world. On the one hand, every industrialized country has experienced a decrease in population growth and is aging rapidly. Not a single nation in Western Europe is producing enough children to maintain prior rates of population growth; and while the United States with its large inflow of immigrants has enjoyed a favorable rate of population growth, even that rate has decreased. Japan will actually experience an absolute population decline early in the twenty-first century. On the other hand, the population in most of the rest of the world has been exploding. The industrializing economies, for example, are undergoing a massive demographic expansion. Between 1950 and 1998, the population of the developing world grew by 3 billion (from 1.7 billion to 4.7 billion); this population is expected to reach 6.8 billion by 2025! By that date, China is expected to have a population of about 1.5 billion, and India's population could reach 2 billion people sometime in the twenty-first century. Less dramatic but still impressive population growth will characterize other developing economies. This demographic shift will, of necessity, have a profound impact on global economic and political affairs.

Unprecedented population growth in impoverished, less developed economies constitutes a massive challenge. Problems of health, environmental degradation, and political instability will ravage many societies, and if these societies see no hope for improving their lot in a market-oriented global economy, they will surely develop the weaponry with which to destroy that economy. The international community must assist such countries to become part of the global economy and must also do what it can to raise the standard of living of billions of unfortunate peoples. Economic development of destitute countries will require huge transfers of capital and technology as well as maintenance of global markets for their exports. However, success in developing previously backward economies will also create additional challenges for the industrialized economies themselves.

Population growth leads to urbanization, and urbanization has historically been associated with large increases in an economy's total factor productivity. This means that, despite the high costs of urbanization, the productivity of an economy generally increases substantially as urban centers grow. Population decline, on the other hand, is associated with a slower rate of productivity growth; and, of course, the aging of a population entails an increasing burden of retirement and medical costs. As the rate of productivity growth determines the wealth and power of a society, one can project a profound shift during the twenty-first century in the global distribution of wealth and power away from the older to the newer industrial powers. Concerns over this shift already appear to be influencing the policies of Japan, Western Europe, and, to a lesser extent, the United States. For example, strengthening the position of the European peoples in the increasingly competitive global economy is an unvoiced goal of the movement toward a united Europe.

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The Challenge of Economic Regionalism

Since the mid-1980s, the movement toward economic regionalism has become a defining feature of the global economy and has had a major impact on its shape. This "new regionalism" (to use Jagdish Bhagwati's term) differs in fundamental respects from the earlier regional movement of the 1950s and 1960s and has much greater significance for the global economy; the only survivor of the earlier regional movement is

the European Economic Community, or, as it is now called, the European Union. The revived movement toward regional integration has been nearly universal, generally successful, and has increased considerably the integration of economic activities within particular regional arrangements. A substantial portion of world trade takes place within regional groupings. All major economies, with a few exceptions such as China, Japan, and Russia, are members of a regional economic bloc. This new regionalism has major implications for the global economy.

The new regionalism was initiated by the Single European Act (1986); that Act stimulated other regional efforts throughout the world, most importantly by the United States. In response to European reluctance to join the American-initiated Uruguay Round of trade negotiations, to growing concerns in the United States that Europe was turning inward, and to impatience with the slowness of GATT negotiations, the United States decided to support the North American Free Trade Agreement (NAFTA). The slow and drawn-out Uruguay Round (1986-1993) WTO itself undoubtedly further contributed to the spread of regional trade agreements. Many nations, fearing that the Round would never succeed, joined regional arrangements, and regional trade agreements (RTAs) proliferated in the 1980s. By the late 1990s, there were approximately one hundred regional agreements, many of which had been negotiated in the 1990s. Every member of the World Trade Organization except Japan, Hong Kong, and Korea was included in one or more formal regional arrangements.

Each step toward West European integration had increased trade barriers for nonmembers and elicited an American response in the form of new multilateral trade negotiations within the GATT. The Dillon (1960–1961) and Kennedy (1963–1967) Rounds significantly lowered barriers raised by creation of the European Economic Community (Common Market), and the Tokyo Round (1973–1979) was a response to the first enlargement of the Community. When it became clear that the 1986 Single European Act would create a united and possibly closed West European market and Europeans resisted a new round of trade negotiations, the United States began to support development of the North American Free Trade Agreement (NAFTA). And in Pacific Asia, largely in response to European and North American regional developments, Japan intensified its own efforts to create a regional economy under its leadership. In Latin America, Argentina and Brazil initiated in 1991 a South American regional bloc (Mercosur).

As more and more developing countries have liberalized their economies to achieve greater efficiency and have abandoned import-substitution strategies, they too have begun to perceive the advantages of regional arrangements that would promote economies of scale for their industries and provide some balance to regionalization in Europe and North America. The expanding movement toward economic regionalism can be described as a response to what political scientists call a "security dilemma" in which each regional movement attempts to enhance its own competitive position vis-à-vis other regions.

The new regionalism has promoted regional integration of both services (finance, information-based industries, etc.) and manufacturing. Whereas previously, regionalism occurred primarily in the form of trade liberalization through customs unions or free-trade areas, regionalization in the 1990s has been accompanied by financial, manufacturing, and other forms of economic integration. Regional corporate groupings and production networks led by multinational firms have been established in Europe, North America, and Pacific Asia. Regionalism has thus had a growing impact on national, regional, and international economic affairs. Both market forces and government policies have led to regionalization of the world economy and caused some to fear that the world economy could fragment into rival blocs centered on the three dominant economies.

Although there is no single explanation of economic regionalism, both political and economic considerations have been involved in every regional movement, with their relative importance differing from region to region. Whereas the movement toward integration of Western Europe has been motivated primarily by political considerations, the motivation for North American regionalism has been more mixed, and Pacific Asian regionalism has been principally but not entirely market-driven. Attainment of political objectives, including ending French-German rivalry and creating a political entity to increase Europe's international standing, has been vitally important in European integration. Establishment of the North American free-trade area has reflected the natural integration of the three economies by market forces, but such

political motives as strengthening North America's position vis-à-vis Western Europe and reducing illegal Mexican migration into the United States have also been involved. And in Pacific Asia, even though market forces have been the most important factor in the integration of the regional economies, political considerations and specific Japanese policy initiatives have played an important role as well .

Every regional arrangement represents the cooperative efforts of individual states to promote both their national and their collective economic and political objectives. Economic regionalism has been a response by nation-states to shared political problems and to a highly interdependent global economy. As the international economy has become more closely integrated, regional groupings of states have increased their cooperation to strengthen their autonomy, improve their bargaining position, and promote other political/economic objectives. Regionalization actually incorporates national concerns and ambitions rather than provides an alternative to a state-centered international system.

The major powers have incorporated economic regionalism in the strategies they employ to increase their own relative gains and to protect themselves against external threats to their economic welfare and national security while also sharing the benefits of an expanding global economy. This development reflects the belief of political and economic leaders that economic competition has become a central focus of world politics. Furthermore, international economic competition necessitates the availability of large domestic markets that enable domestic firms to achieve economies of scale. In order to survive and prosper in an uncertain and rapidly changing world, individual states and groups of states are adapting to the evolving economic, technological, and political environment as they have many times in the past. States have responded to an intensely competitive and threatening globalization by forming or extending regional economic alliances and arrangements under the leadership of one or more major economic powers.

The purpose of the Treaty on European Union, or Maastricht Treaty (1991), was to create a politically and economically unified European Union (EU) that would be the equal economically of Japan and the United States. The United States, Mexico, and Canada ratified NAFTA to create a strong North American integrated economy and perhaps eventually an entire Western Hemisphere one. In Pacific Asia, Japan has also attempted to strengthen its global position by creating a regional economy. These three movements toward regional integration and the relationships among the movements will have a profound impact on the nature and structure of the global economy.

At the opening of the twenty-first century, resolution of the tension between economic globalization and economic regionalization has become critically important to the health of the world economy. American economists have generally believed that economic globalism will eventually triumph over regionalism, and they argue that since World War II there has been an irreversible linear movement toward global interdependence. Inexorable economic and technological forces are believed to be driving the economies of the world toward ever higher levels of integration, and movements toward regional integration are viewed as building blocks in the construction of a larger and borderless global economy. This general process of economic integration and globalization has occasionally been blocked by irrational forces when parochial interests threatened by the forces of economic integration have appealed to nationalist passions and been granted protection. Nevertheless, some have argued that, in time, the inherent logic of economic efficiency will prevail, and nations will continue to move toward increased globalization. As C. Fred Bergsten has put it, although almost all countries have at one time or another attempted to resist international market pressures, such movements can succeed only in part and only for a short period.[18] Thus, try as they might, nations and regions ultimately cannot escape the inexorable forces of global unification.

Envisaging a different scenario, a minority of economists and many other observers believe that the end of the Cold War and intensification of global economic competition mean that the international economy will continue to fragment into regional economic blocs centered on the dominant economic powers. Furthermore, as regional arrangements are politically as well as economically motivated, they are likely to be influenced by protectionist pressures. Some assert, moreover, that such regional arrangements as NAFTA and the EU have the capacity to exploit their market power and implement an optimum tariff or a strategic trade policy and thus increase the benefits of trade for their own members to the disadvantage of nonmembers. In addition, the political and distributive deals that have been arranged to make a regional agreement politically possible cannot easily be undone. In the case of NAFTA, the benefits gained by American, Mexican, and Canadian automobile and auto-parts producers mean that the North American market in these sectors is unlikely to be opened to free trade anytime soon. Indeed, many observers consider a regionalized world the only realistic alternative to the dangers of economic nationalism and trade protectionism. In a world where national rivalries, oligopolistic competition, and state intervention rather than free and open markets are prevalent, global trade liberalization can proceed only so far.

A third position, with which I myself agree, argues that a dialectical process has been taking place in the world economy. There is no linear process in which the forces of global economic integration will eventually triumph over economic nationalism and economic regionalism, but the world is unlikely to fragment into regional blocs. Adherents of this position expect that economic globalism and economic regionalism will prove complementary. These seemingly contradictory developments, as one scholar has stated, actually reflect a world in which states use regional arrangements in an attempt to control what they have failed to control at either the national or multilateral levels.[19] Nation-states, as they have in the past, are again adapting to the rapidly evolving economic, technological, and political environment through various efforts to survive and prosper.

Managing the Global Economy

The task of managing the international economy has been made more important and more difficult by globalization and by the global economic turmoil of the late 1990s. Increasing integration of the world by powerful economic and technological forces has led more and more observers to believe that the world economy has become unstable and even out of control. An extreme yet representative statement of this concern appeared in a 1998 article in the *New York Times Magazine* by a former United States Treasury official stating that markets have become the ruling international authority; they are even more potent than military power or political influence and, arrayed against a nation, markets can cause hitherto unthinkable changes.[20] Although this article's writer, Roger C. Altman, believed that globalization could encourage the spread of democracy, he warned that a recent and frightening aspect of globalization had been revealed in the East Asian financial crisis. Although one may disagree with Altman's characterization of the good and bad consequences of globalization, one should acknowledge his stark but accurate statements that integration of the world economy has taken place much more rapidly than has development of a capacity to manage the new economic and technological forces. And, as Paul Krugman has asserted, many if not most of these troubles arise because the world economy is only partially integrated; that is, because economic integration has greatly outpaced political integration.

At the Bretton Woods Conference international rules (called "international regimes" by scholars) were established to govern international trade and monetary affairs. Although the system functioned effectively during the first decades of the postwar era, management became increasingly difficult as globalization increased integration of national economies and economic regionalism began to fragment the world economy in the 1980s. Governing the global economy became still more difficult as American leadership waned, the anti-Soviet alliance atrophied, and citizens in the industrialized countries grew increasingly concerned over the consequences for jobs and wages of the intensification of economic competition.

There have been, in fact, only two eras of effective governance of the world economy, and they have been the most prosperous eras in history. The first occurred in the several decades just prior to World War I; the outbreak of the war brought this remarkable era to a close. After the disastrous decades of the 1920s and 1930s, the second era of expanding economic prosperity immediately followed World War II. This era of very rapid economic growth (at least for the United States and Western Europe) closed with the stagflation of the 1970s and has not been reopened, despite the "good times" experienced by the United States in the 1990s. These two periods of unusual economic growth accompanied by international stability were characterized by a coincidence between the interests of the dominant power and the requirements for creating and maintaining a liberal world economy. Great Brit-

ain in the earlier era and the United States in the latter were able and willing to use their power and example to provide effective governance of the world economy. However, the circumstances surrounding the reigns of these two dominant, or hegemonic, economic powers were vastly different.

The task of governing the world economy in the decades prior to World War I was modest because the purpose of economic activity was modest. The remarkable decades from the early 1880s to 1914 were the high points of free trade and economic laissez-faire; the free market and economic globalization reached achievements that have not been equaled before or since. The British opted for trade liberalization when they repealed the Corn Laws (1846) and subsequently promoted free trade through a series of bilateral treaties. The international monetary system, based on the classical gold standard, provided price and monetary stability. As most other countries were also on the gold standard, the Bank of England was able to steer the world economy by lowering or raising interest rates. Economic growth, employment, and investment around the world rose or fell in response to decisions taken by "The Old Lady of Threadneedle Street" (the Bank of England), and immense British capital exports contributed greatly to the development and unification of the world economy. Objective economic laws beyond the reach of governments were believed to govern the market, but such views changed dramatically following the Great Depression of the 1930s and the development of Keynesian economics.

In the 1930s, powerful states and domestic interest groups (both large firms and organized labor), unwilling to leave economic matters up to the market, abandoned laissez-faire, and national governments began to play a more central role in the determination of international commerce. Although the emergence of powerful state and domestic actors called for more positive and assertive management of the world economy, none was forthcoming. The Great Depression of the 1930s, fragmentation of the world economy into rival political/economic blocs, and the outbreak of World War II prevented development of any solution until the United States asserted leadership following World War II.

With the United States as the leader, the Bretton Woods system was established, trade liberalization was promoted through the GATT, and the dollar was assigned an international role and became an important source of international monetary stability. In the 1960s and beyond, however, the quality of American leadership deteriorated. The Nixon Administration's jettisoning of the system of fixed exchange rates in 1971, the American-led movement toward New Protectionism in the mid-1970s, the significant shift of the Reagan Administration in the mid-1980s from multilateralism to a multitrack foreign economic policy, and the Clinton Administration's aggressive pursuit of geo-economics and strategic trade policy all seriously undermined the fundamental principles of the Bretton Woods system. Following the end of the Cold War, the United States and its allies began to pursue more parochial policies and to emphasize regional rather than global solutions to economic problems. Indeed, since the mid-1980s, the West Europeans have concentrated on the process of European economic and monetary unification. At the domestic level, more and more Americans, West Europeans, and others have questioned the costs of free trade, unregulated financial movements, and the freewheeling activities of multinational corporations.

These developments have raised again the issue of governing or managing the global economy, and that raises an even more fundamental question: What is the purpose of governance? During the Cold War, the fundamental purpose of the world economy was to strengthen the economies of the anti-Soviet alliance and solidify the political unity of the United States with its allies. Although the global economy, or at least those economies outside the tight Soviet bloc, was based on economic principles such as free trade and (after the mid-1970s) freedom of capital movements, these principles were set aside whenever necessary to serve the political purpose of increasing the strength of Allied economies and the cohesion of the anti-Soviet alliance. A notable example was the formation of the European Economic Community by the Treaty of Rome (1957), a violation of the principle of nondiscrimination and of at least the spirit of Article XXIV of the GATT regarding regional economic agreements. Now that regional economic arrangements have become the norm rather than the exception, it has become more important than ever to determine a new purpose for the global economy of the twenty-first century and the principles on which it should be based.

Many, if not most, American public officials, business leaders, and professional economists, as well as many commentators, believe that the issues of management and economic purpose have already been determined. The global economy, according to this position, should be guided by the policy prescriptions of economics and be based on market principles. Free trade, freedom of capital movements, and unrestricted access by multinational firms to markets around the globe henceforth should govern international economic affairs. With the triumph of the market, economic logic and the relative efficiencies of national economies will determine the distribution of economic activities and wealth (and, of course, power) around the world. Moreover, the success of the United States in the 1990s and the serious economic problems of Japan and East Asia in that same period are believed to have demonstrated the superiority of the American market-oriented economic model.

The reality of "the market triumphant" is challenged by many political leaders, powerful interest groups, and public commentators around the world. In the industrial economies, this dissent generally takes the form of opposition to globalization as a threat to employment, wages, and job security. Some individuals and groups consider that free trade and the activities of multinational firms threaten livelihoods and communities; free trade and foreign investment, they argue, are not the route to economic prosperity for workers and others disadvantaged by globalization. In many less developed and industrializing countries, as nineteenth-century critics of international capitalism proclaimed, "free trade is the policy of the strong," as are international financial movements and foreign investment by multinational firms. Although opponents to a market-governed international economy are less influential than its proponents, their numbers have increased in proportion to the increasing globalization and the growing role of international markets in determining the economic welfare of people everywhere.

As one considers the prospects for a market-governed world economy, it is important to remember that economists themselves are deeply divided over the principles that should guide the post–Cold War international market economy. There is near unanimity among economists on the virtues of free trade; indeed, as Paul Samuelson has said, the law of comparative advantage (upon which the doctrine of free trade is based) is "the most beautiful idea in economics." However, beyond the issue of trade, agreement within the economics fraternity rapidly dissipates. For example, although most economists appear to favor unfettered capital markets, a number of very distinguished economists, including Nobel Laureate James Tobin and Jagdish Bhagwati, one of the world's foremost international economists, challenge the wisdom of permitting unregulated international financial flows; finance, they argue, is too important to be left in the invisible hand of the market. There are also serious differences among economists concerning the international monetary system, economic regionalism, and economic development, as well as other important matters. Thus, there are few agreed-upon fundamental principles beyond the belief in free trade on which to base a market-determined global economy.

Conclusion

This book argues that, although the post–World War II international economic order no longer exists, no agreement has yet been achieved regarding a new world economic order or its rules and guiding principles. The purpose of economic activities is determined not only by the prescriptions of technical economics but also (either explicitly or implicitly) by the norms, values, and interests of the national social and political systems in which economic activities are embedded. Even though economic factors will play an important role in determining the characteristics of the global economy, the most important factors are and will be political. The characteristics are and will be determined largely by the security and political relations among the major powers, including the United States, Western Europe, Japan, China, and Russia.

Markets by themselves are neither morally nor politically neutral; they embody the values of society and the interests of powerful actors. Whereas the post–World War II economy reflected to a considerable degree the political, economic, and security interests of the United States and its allies, the nature and functioning of the twenty-first-century global economy will ultimately be determined by the power and interests of its dominant members. While it is impossible to ascertain the outcome of present and future interactions between economic

and political affairs, it is quite unlikely that powerful states will leave such vital matters as the distribution of wealth, industry, and power up to the unencumbered interplay of market forces. Nor is it likely that nations will sacrifice economic autonomy, political independence, and security concerns to a maximization of the efficient functioning of the global economy. Both economic efficiency and national ambitions, particularly those of the dominant powers, will be driving forces in the global economy of the twenty-first century and will ultimately determine its economic and political purpose.