Week 5

W.5

PART I

ORIGINS

CHAPTER 1

THE MODERN CAPITALIST WORLD ECONOMY: A HISTORICAL OVERVIEW

JEFFRY A. FRIEDEN

CAPITALIST economic activities are of very long standing—some would say they were present in proliferation during Roman times.[1] By the late medieval and early modern period, large areas of Western Europe had thriving, relatively free markets for labor and capital, both in the city and in the countryside. We can most fruitfully and confidently speak of the full flowering of modern capitalism once it became a truly international economic order. That epoch evolved over the course of the sixteenth, seventeenth, and eighteenth centuries, as capitalism expanded from a limited Western European base to affect much of the world, from the Americas to East Asia.

A MERCANTILIST WORLD ECONOMY

Market economies flourished in many parts of Europe during the high and late Middle Ages, most prominently in Italian commercial and manufacturing centers such as Genoa, Venice, and Tuscany. Although they relied heavily on long-distance trade, these islands of capitalism had little structural economic impact on the rest of the world. But after the 1450s, the Ottoman Empire's control of the Eastern Mediterranean drove Europeans out into the Atlantic, and eventually around the world, in search of trade routes. Western Europeans' eventual recognition of the economic potential of the New World and of more consistent interaction with Africa and Asia opened a new era.

For nearly four centuries, from the mid-1400s to the mid-1800s, the rest of the world was drawn into an economic and political order dominated by European capitalism. This order was organized around the overseas colonial empires of the Atlantic powers: first Spain and Portugal, then the Netherlands, England, and France. This was the first true international economy, and it was controlled in a very particular manner by its European founders. The economic system they built has come to be known as mercantilism.

Mercantilist ordering principles defined the international capitalist economy for several hundred years. Although there was variation among the principal mercantilist powers, the system's main features were common to all. First and foremost, mercantilism depended on substantial government involvement in the economy. These were, after all, colonial systems, and military might underpinned the predominance of the colonial powers over their possessions. But that was not all. Mercantilist governments considered their economic policies to be part and parcel of broader national goals, especially in the continuing struggle for diplomatic and military supremacy. Mercantilism enriched the country and the Crown, which then used those riches to build up military force. "Wealth is power," wrote English philosopher Thomas Hobbes, "and power is wealth." One of his fellow mercantilist thinkers drew the connections: "Foreign trade produces riches, riches power, power preserves our trade and religion."[2]

The mercantilist economic order relied on systematic government intervention in the economy, particularly in international economic transactions. Although there was variation among countries and over time, core mercantilist goals and policies were similar. Mercantilist governments tried to stimulate demand for domestic manufactures and for such national commercial and financial services as shipping and trade. They did this, typically, by requiring their colonies to sell certain goods only to the mother country (the "metropole") and buy certain other goods only from the mother country. Restrictions on trade turned the terms of trade against the colonies: prices of colonial exports were depressed, while prices of colonial imports were elevated. This, of course, benefited metropolitan producers, who could purchase their inputs (raw materials, agricultural products) at artificially low prices and sell their output (manufactures) at artificially high prices. Virginia tobacco farmers had to sell their leaf to London, although Amsterdam would have paid more; they had to buy their cigars from London, although Amsterdam would have charged less. The rents created this way went to enrich the manufacturers and "merchant princes," whose alliance with the Crown characterized the mercantilist political economy.

Mercantilist governments also required many international economic transactions to be carried out by their preferred, national agents: shipping, insurance, finance, wholesale trade. In some cases, trade had to be channeled through certain favored ports. Like import and export restrictions, this provided rents to the privileged. The colonial governments also endeavored to discover and exploit precious metals. The Crown usually took (or taxed very heavily) the gold and silver discovered in the colonies. Mercantilist governments typically chartered monopolistic enterprises to which they delegated both economic and administrative functions in the colonies, such as the Hudson's Bay Company and the Dutch East India Company.

Mercantilist policies achieved several interrelated goals. They provided revenue for the government. This might come directly from precious metals and other forms of tribute or indirectly from the revenue provided by those enriched by the policy. This was one sense in which mercantilist economic policies supported the broader diplomatic and military goals of the government: they made available the wherewithal to sustain and increase national power. Mercantilist policies also aimed explicitly at encouraging early manufacturing, seen as central to modern economic and military advance.[3] And the restraints on trade and monopolistic charters cemented ties between the government and its powerful supporters in business.

The political economy of mercantilism was largely based on an implicit or explicit alliance between the government—the Crown, except in the Dutch Republic—on the one hand, and the merchants, manufacturers, and investors that carried out the bulk of economic interactions with the colonies on the other.[4] The character of this alliance varied from country to country. In the Netherlands, the mercantile classes effectively and directly controlled the state; in the other colonial powers, the government had interests of its own, which sometimes conflicted with those of its business allies. The Spanish Crown, for example, was particularly concerned with consolidating its control over the country, which was only fully freed of Muslim rule in 1492, and in which there were powerful regional noblemen. This made the Spanish Crown more insistent on centralizing control and revenue and less willing to encourage the rise of powerful private actors than many other mercantilist rulers.

Mercantilist policies benefited the favored metropolitan businesses, at the expense of the colonies (and consumers). To be sure, some colonial subjects valued membership in a powerful empire, especially inasmuch as the empire protected them from others. While many citizens of Great Britain's North American colonies chafed at mercantilist restrictions on their trade, many others appreciated the security British naval and military power provided.

The mercantilist era's main characteristics highlight enduring features of modern capitalist economies. The first is an ambivalent relationship with the world economy. To be sure, the leading colonial powers were heavily oriented toward engagement in the international economy and eager to take advantage of what the rest of the world economy had to offer. At the same time, mercantilist policies were highly nationalistic and strongly protected the home market and national producers from foreign competition. This tension, between the desire to take advantage of international economic opportunities, on the one hand, and the fear of harm from foreign competition, on the other, is a recurring theme in capitalist attitudes toward the world economy. The mercantilist powers dealt with the issue by aggressively expanding their access to foreign markets, but jealously guarding and protecting the markets they conquered within their colonial empires.

A second feature of the mercantilist experience was the tension between state and markets. In the mercantilist period, as at other times, market actors wanted economic freedom, and governments wanted the prosperity markets could provide. Indeed, markets were almost certainly much better developed and much freer in this era than they had been in the previous medieval centuries. At the same time, mercantilist governments were aggressive in their intervention in the economy. To some extent this reflected real or imagined demands of national security and military power, in an attempt to harness economic dynamism to national goals. To some extent it reflected the interests of powerful economic interest groups, which were enriched by state-enforced monopolies, state controls on trade, and the backing of their governments. The result was a mix of state intervention and market development—not always harmonious.

Indeed, these two dimensions have been at issue throughout the history of capitalism. The first is the international-national dimension: the conflicting desire for integration with and insulation from the world economy. The second is the state-market dimension: the conflicting desire for government involvement in markets and market freedom from government. Over time, both countries and the world in general have oscillated between periods of greater and lesser economic openness and between periods of greater and lesser government intervention in the economy.

Mercantilism reflected the economic and political realities of its era. Western European economies had advanced enough beyond those in the rest of the world, both in technology and in organization, that their predominance was largely unchallenged. Meanwhile, previously unimaginable overseas economic prospects had opened up, a whole world of resources and markets that could be tapped and, in most cases, controlled. This provided the incentive, to rulers and capitalists alike, to assert themselves wherever possible. At the same time as the mercantilist powers were subjugating vast areas to their colonial control, they engaged in continuing conflicts with one another for supremacy. This gave them powerful motivations to use their colonies to enhance their military might and to use their military might to amass more colonies. Domestically and internationally, at home and abroad, the mercantilist systems generally reflected a mutually rewarding partnership between rulers and capitalists, enriching both and drawing most of the world into their orbit.

The End of Mercantilism

A combination of political and economic developments began to erode the mercantilist system. Politically, one of the attractions of mercantilist policies had been their connection to the struggle for diplomatic supremacy: reserving access to colonies to the home country and restricting it to others served to help the government amass resources for military purposes and to deny resources to real or potential enemies. But in 1815, a British-led alliance defeated Napoleon at Waterloo and effectively ended three centuries of warfare among the Atlantic powers. With British maritime supremacy ensured, and the Continent largely stable, the military arguments for mercantile colonialism faded.

Domestic political trends also undermined the mercantilist system. Throughout Western Europe, autocratic dynastic rule came under challenge, largely from the rising business and middle classes. Although political reform was slow, and certainly did not result in anything we would recognize as democratic, it did loosen the exclusive grip on power of some previously favored groups. Among these were the monopolistic enterprises created and favored by mercantilist policy, whose preferential position was increasingly resented by more modern entrepreneurs in industry, trade, and finance. As the foreign policy arguments for mercantilism faded, so did the domestic political alliances underpinning it.

Economic trends also eroded the previous political economy. Most important was the rise of modern industry. Manufacturing in the earlier era, though certainly an advance over the medieval norm, was on a small scale, often based on cottage industry. Over the course of the eighteenth and early nineteenth centuries, manufacturing was fundamentally transformed, especially in Great Britain and some areas of Northern Europe. A flurry of technological innovations revolutionized production. Employers brought dozens, even hundreds of workers together in large factories to use new machinery, new energy sources, and new forms of organization. Power looms and mechanical spinners transformed the textile industry. Improvements in the use of water power, and eventually the development of steam power, made the machinery more powerful still. The Industrial Revolution and the rise of the modern factory system meant that the new industries could undercut competitors in virtually every market, which made mercantilist barriers to trade either irrelevant or harmful.

Great Britain led the way in gradually jettisoning mercantilism. As British military predominance was secured, both Crown and Parliament were less concerned about tight colonial control. Many in Britain had indeed, as far back as the American Revolution, begun to regard the cost of keeping the colonies as outweighing the benefits. As Parliament, increasingly representative of business and middle-class interests, imposed ever greater restrictions on royal prerogatives, it increasingly challenged the royally chartered monopolies.

As the British economy evolved, dissatisfaction with mercantile controls grew. British industrialists wanted to eliminate the country's trade barriers. Removing restrictions on imports would allow British producers access to cheaper inputs and would give British consumers access to cheaper imported food, which would allow factory owners to pay lower wages without reducing workers' standard of living. At the same time, industrialists believed that removing trade restrictions would increase world demand for British goods. For these reasons, Britain's manufacturing classes and regions developed an antipathy to mercantilism and a strong desire for free trade.

As the city of London became the world's financial center, it added its influence to that of other free-trade interests. Britain's international bankers had a powerful reason to open up the British market to foreigners: the foreigners were their customers. American or Argentine access to the thriving British market would make it easier for Americans and Argentines to service their debts to London. The industrial and financial interests mounted a concerted attack on what antimercantilist crusader Adam Smith called "the mean and malignant expedients of the mercantile system."[5] By the 1820s those "malignant" mercantilist expedients were under constant challenge.

The battle over mercantilism was joined especially over the Corn Laws, tariffs imposed during the Napoleonic Wars on imports of grain.[6] Industrialists and financiers opposed the agricultural tariffs, as did the urban middle and working classes, and were opposed by the country's powerful farmers. The free traders won after a protracted struggle. They might not have prevailed had there not been a major reform of British political institutions: a changed electoral system that reduced the power of farm constituencies and increased that of the cities and their middle-class residents. Even with the electoral reforms in place, the final votes in 1846 and 1847 were extremely close and tore the Conservative Party apart. A few years later, Parliament repealed the last vestiges of British mercantile controls on foreign trade.

The Classical Era: Free Trade and the Gold Standard

After Britain, the world's most important economy, discarded mercantilism, most of the other major economic powers followed suit. In 1860, France joined Great Britain in the Cobden-Chevalier Treaty, which freed trade between them and helped draw the rest of Europe in this direction. As the German states moved toward unification in 1871, they created a free trade area among themselves, then opened trade with the rest of the world. Many New World governments also liberalized trade, as did the remaining colonial possessions of the free-trading European powers. Mercantilism was dead, and integration into world markets was the order of the day.[7]

Over the course of the nineteenth century, much of the world opted for general openness to the international economy and for a reduced level of state involvement in the economy. Although mercantilism had been marked by a strong role for the government in both domestic and international economic affairs, the classical order that arose over the course of the 1800s saw a dramatic reduction in government involvement on both dimensions.

Technological change dramatically reduced the cost of international economic exchange, making an open economy that much more attractive. Over the course of the century telegraphs, telephones, steamships, and railroads replaced horses, carrier pigeons, couriers, and sails. The railroad fundamentally changed the speed and cost of carrying cargo over land. The steamship revolutionized ocean-going shipping, reducing the Atlantic crossing from over a month in 1816 to less than a week in 1896.

The new technologies took hold and diffused very rapidly, even in developing regions. In 1870, Latin America, Russia, Canada, Australia, South Africa, and India combined had barely as much railroad mileage as Great Britain. By 1913, these regions had ten times Britain's railroad mileage. Argentina alone went from a few hundred miles of rail in 1870 to a system more extensive than Britain's.[8] On the seas, there was a twentyfold increase in the world's shipping capacity during the nineteenth century.[9]

These advances reduced the cost of land transportation by more than four-fifths and of sea-going transport by more than two-thirds. Europe flooded the world with its manufactures and was in turn flooded with farm products and raw materials from the prairies and the pampas, the Amazon and Australia. Over the course of the 1800s, the trade of the advanced countries grew twice to three times as fast as their economies; by the end of the century, trade was seven or eight times as large a share of the world's economy as it had been at the beginning of the century.[10]

International investment also soared. As telegraphy allowed information to be transmitted instantaneously from any reasonably developed area to investment houses and traders in London, Paris, and Berlin, new economic opportunities attracted the interests of European savers like never before. Foreign capital flooded into rapidly growing regions in the New World, Australia, Russia, and elsewhere. By the early 1900s, foreign investments, largely in bonds and stocks, accounted for about one-third of the savings of the United Kingdom, one-quarter of France, and one-tenth of Germany.[11] This was also an era of virtually free international immigration, at least for Europeans. Some fifty million Europeans moved abroad, along with another fifty million Asians. Markets for goods, capital, and labor were more tightly linked than they had ever been.

Perhaps the most striking, and most powerful, organizing principle of global capitalism during the nineteenth century was the gold standard. After centuries of stable bimetallism, in the 1870s governments were faced with a choice. New silver discoveries drove the price of silver down and made the existing rate of exchange between the two metals unstable, so governments had to either change the rate or choose between gold and silver. Meanwhile, as international trade and investment grew, gold—the traditional international medium of exchange—became more attractive than domestic silver. Finally, Great Britain had been on gold since 1717, and its status as the global market leader attracted other countries to use the same system. In the 1870s most major industrial countries joined the gold standard, with more countries joining all the time. By the early 1900s, the only two countries of economic importance not on gold were China and Persia.

When a country's government went "on gold," it promised to exchange its currency for gold at a preestablished rate. This provided an important degree of predictability for world trade, lending, investment, migration, and payments. The impact on trade was substantial; being on gold in this period is variously estimated to have raised trade between two countries by between 30 and 70 percent.[12] The gold standard was even more important for international finance than it was for trade. International financiers regarded being on gold as an obligation of well-behaved members of the classical world economy, a signal of a country's economic reliability.[13] Investors had good reasons to focus on government commitments to the gold standard. The balance of payments adjustment mechanism under the gold standard might require a government whose economy was running a payments deficit to reduce wages and spending to move back toward balance. To stay on gold, governments had to be able to privilege international ties over domestic demands, imposing austerity and wage cuts on unwilling populations if necessary. This made the gold standard a litmus test that international investors used to judge the financial reliability of national governments.[14] Membership in the gold club conferred a sort of blessing on its initiates, and gave participating countries access to an enormous pool of international savings.

Technological and policy change turned a world of closed colonial empires into an integrated global economy. The results were impressive by almost any standard. Transportation and communications improvements, along with policies to further economic integration, led to a significant convergence of prices.[15] This in turn created important opportunities for countries to gain access to world markets for goods and capital. As railroads, steamships, and eventually refrigeration brought grain and beef prices in Omaha and Buenos Aires up toward European levels, rural backwaters quickly became some of the most attractive places in the world to farm and invest.

Economic integration also led to convergence of levels of development, as many of the countries drawn into this new world economy grew very rapidly. Industrialization spread from its Northwestern European homeland to the rest of Europe and much of the world. Great Britain was overtaken: in 1870, British iron and steel production was greater than that of Germany and the United States combined, while by 1913 Germany and the United States combined outproduced the United Kingdom roughly six to one. This was true also of living standards: per capita incomes in the United States, Australia, and New Zealand were higher than in the United Kingdom, and Argentina and Canada were gaining fast.[16] Although there were periodic panics and recessions, the 100 years from 1815 to 1914 were marked by a general macroeconomic stability that matched the general stability of diplomatic affairs—which is why the era is often called the Hundred Years' Peace or the Pax Britannica.

Whatever its economic achievements, there were plenty of evils in the classical era. The end of mercantilism was associated with a decline of the early colonial empires, especially in the New World. But in the 1880s, the major powers began accumulating new colonial possessions. Europe's colonialists divided most of Africa, Southeast Asia, and East Asia among themselves (and Japan); the United

States joined the fray in the Pacific and the Caribbean. Many of the new empires were run on lines reminiscent of mercantilism, giving preferential treatment to the colonial power's economic interests, although the monopolistic features were typically more muted. Some colonies were afforded reasonable treatment; but some were mercilessly exploited. The horrific abuses of Belgium's King Leopold in the Congo were particularly egregious (Hochschild 1998). In part as a result, many parts of the world—especially in Africa and Asia—stagnated or declined economically even during the best of times.

The classical economic order was also no political idyll. Leaving colonialism aside, political rights were severely limited even in the industrial world. Most of the developed nations made no pretense of being democratic; those that did had such restricted franchise and limited freedom that today we would not consider them democratic. Indeed, limited political voice by farmers and the middle and working classes may well have been essential to the ability of governments to play by the rules of the classical game: it is hard to imagine truly representative governments being able to impose the austerity measures necessary to sustain economic openness in a world largely without social safety nets.

The economic dislocations created by economic integration were also not trivial. As cheap farm products flooded into Europe from the New World, Australia, Russia, India, and elsewhere, most of the Continent's farmers were made redundant. For decades, much of Europe suffered through a wrenching agrarian crisis. Tens of millions left the land to resettle in the cities or move abroad. Others demanded protection from imports, and sometimes governments provided this. Foreign competition also harmed many traditional producers in the developing world, who could not compete with inexpensive factory products.

Nonetheless, despite problems and challenges, a recognizable economic order prevailed over most of the world in the nineteenth and early twentieth centuries. This order was almost the diametric opposite of mercantilism. Where the mercantilist system was based on aggressive closure of home and colonial markets to foreigners, the norm in the classical period was of openness to international trade, investment, and migration. Where mercantilism presumed extensive government intervention in the economy, both at home and abroad, governments in the classical system tended—with variations—to leave markets largely to their own devices. Both international openness and a market orientation were debated and contested, but both prevailed most of the time and in most countries.

The classical international economic order that reigned in the nineteenth and early twentieth centuries has to be considered generally successful. The world economy as a whole grew more in the 75 years before 1914 than it had in the previous 750. There was a great deal of convergence as many poorer countries grew more rapidly than rich countries. Goods, capital, technologies, information, ideas, and people moved quite freely around the world. Macroeconomic conditions were stable overall, economic relations among the major economic powers were generally cooperative, and there was a broad consensus about the desirability of sustaining an open world economy.

The Interwar Collapse

Despite the achievements of an integrated international economy in the previous century, it came to an end with World War I, and efforts to re-create it failed for the next twenty years. Instead, capitalism turned inward, in some cases toward the most insistently nationalistic policies in modern history. In much of the world, a general trend toward engagement with the world economy and in the direction of minimal government involvement in markets was reversed almost completely.

World War I had two profound and lasting effects. The first was to shift the center of gravity of the world economy definitively away from Europe and toward the United States. The war absorbed the energies of the European belligerents and drew them out of their colonial possessions. The United States rushed into the vacuum this created, supplying the belligerents with everything from food to weapons and supplanting the Europeans as principal traders, lenders, and investors in much of the developing world. By 1919, the United States had gone from being the world's largest debtor to its leading lender, and it was also the arbiter of the economic and political settlement worked out among the warring parties at Versailles.

The second enduring effect of the war was to change the political landscape of Europe. Although political institutions had gradually become more representative over the course of the previous century, on the eve of the war they remained quite limited. The war led to a remarkable increase in the depth and breadth of democratic reform, especially in Europe. In part this was due to the collapse of four autocratic empires—the Russian, Austro-Hungarian, Ottoman, and German—and their replacement by successor states, many of which were democratic. In part, democratization was a direct result of belligerent governments' attempts to garner support for the war effort, in particular from socialist parties and their working-class bases of support. Many European governments rewarded popular backing for the war with some combination of political representation, social reform, and labor rights. By the early 1920s almost every industrialized nation was governed by a civilian democracy with universal male suffrage, and many had universal female suffrage as well. Largely as a result, over the course of the interwar years, Europe's socialist parties—generally anathema, often illegal, before 1914—were parliamentary fixtures and frequent members of ruling coalitions.

The rise to economic predominance of the United States had a number of implications. It symbolized a significant change in the nature of modern capitalism. By the 1920s, the United States had pioneered a path soon followed by other industrial nations,—toward an economy dominated by mass production and mass consumption. Some of this was the result of economic growth. As incomes rose, the demand for consumer goods beyond food, clothing, and shelter grew, especially to include more sophisticated consumer durables—including such recently invented ones as the radio, the phonograph, the telephone, the refrigerator, and the automobile. More and more of what industry produced was aimed at the general public.

The ways industry produced evolved along with its products. Technological advances in production, especially the spread of electricity and electrical machinery, drove increases in the scale of manufacturing, including the use of the assembly line. Organizational developments gave rise to the modern multiplant corporation, integrating many stages of the production process; some of the new industrial corporations became multinational. Corporations grew, and oligopolies came to dominate many markets. At the same time, labor unions organized much larger shares of the labor force.

Where the typical industrial economy of the nineteenth century was characterized by small firms, family farms, and unorganized workers, by the 1920s most major industrial economies were dominated by oligopolistic corporations and organized labor unions. Modern societies were driven by big business and big labor. The automobile industry was both typical of and in the forefront of the change: by the 1920s, motor vehicle production was the largest industry in most developed societies; the sector was dominated by large corporations and, in many instances, large labor unions.

In addition to the more general impact of American-style capitalism, the economic rise of the United States had some more specific effects. The United States largely determined the shape of the postwar settlement, as the Treaty of Versailles that ended the war largely followed the proposals of U.S. President Woodrow Wilson. These included institutionalized cooperation among the major powers, on economic issues as well as others. But almost as soon as the American blueprint was put in place, with the League of Nations and a series of monetary and economic conferences, the United States turned its back on the rest of the world. In 1920, a Republican Party committed to "isolationism" swept the presidency and both houses of Congress. The isolationists were hostile to international cooperation on economic matters that they felt would compromise U.S. autonomy.

The United States remained the most important trading, investing, and financial center in the world, but the government largely withdrew from international economic affairs. The impact of this was compounded by the enduring hostility among the former European belligerents. This made it extremely difficult for the major economic powers to work together on international economic issues.

The difficulties of interwar cooperation, and a more detailed examination of earlier experiences, demonstrated the importance of purposive collaboration to maintain an open international economic order. During the classical era, there had been a widespread belief that an integrated world economy was self-regulating and self-sustaining. Although this may have been true of some markets, and to a limited extent to the operation of the gold standard, it was clearly not the case with the global economic order itself. There had been very substantial cooperation among the major financial and monetary centers, especially in times of crisis. Monetary authorities lent substantial amounts to foreign governments facing financial difficulties and helped organize concerted efforts to stabilize markets.

More generally, the classical international economic order had depended on the willingness and ability of participant governments to adjust their domestic economic activities to international economic conditions. This meant, most important, allowing and reinforcing the austerity measures required to restrain—even reduce—wages and prices as necessary to maintain a national commitment to the gold standard. This in turn was possible due largely to the fact that those principally affected by this austerity—farmers, workers, the middle classes—tended to be underrepresented, or not represented at all, in the political systems of the classical era.

But the spread of democracy after World War I meant that most industrial-country governments faced substantial political opposition to attempts to impose gold standard–style adjustments.[17] Unlike in the nineteenth century, by the 1920s farmers, workers, and the middle classes were well represented in national political systems and strongly resisted adjustment measures that had been imposed with relative ease in an earlier era. The classical system had been based on a consensus among elites in favor of an open international economic order. The national political economies that emerged from World War I largely lacked such a consensus.

The interwar years were marked by almost continual conflict among the major economies. Attempts at monetary cooperation were largely inconclusive or failures. Trade policies tended to become more protectionist over time. Important financial problems—such as war debts owed by the Allies to the United States, or reparations owed by the Germans to the Allies—created continual frictions.

Over the course of the 1920s, as economies recovered rapidly, political difficulties seemed less important. At the start, the immediate postwar years were very difficult in Central and Eastern Europe. The new successor states struggled to put their economies on a sound financial footing, often after suffering through several years of very high and hyperinflation. By the time Germany's hyperinflation was brought to an end in 1923, the price level was one trillion times what it had been in 1919. But by 1924, economic growth had been restored in most of the Continent and in the rest of the world. Over the next few years, countries gradually came back to the gold standard, international investment reached and surpassed the prewar levels, and international trade grew rapidly. Latin America and many of the more advanced colonies increased their primary exports dramatically and regained access to international capital markets—especially to loans from the new U.S. lenders. It appeared that the world economy had been restored in something similar to its former conditions.

However, the underlying weaknesses of the post–World War I settlement became painfully obvious when crisis hit in 1929. What started as a minor recession dragged on and on, exacerbated by growing conflict among the major financial centers. Debtors in Latin America and Central and Eastern Europe defaulted, exacerbating financial distress. Financial and currency crises raced through Europe, eventually driving most of the region's countries off gold. Desperate governments raised trade barriers, imposed capital controls, and restricted currency convertibility in an effort to combat the growing crisis.

From 1929 until 1936, virtually every attempt at a cooperative response to the crisis failed. Meanwhile, insistent government attempts to implement the kind of austerity measures that had worked reasonably well in the classical era ran into economic and political obstacles. Economically, gold standard–style adjustments had been relatively rapid in the nineteenth-century environment of small firms, small farms, and unorganized labor, which made for quite competitive markets and flexible prices and wages. But in the conditions of the 1930s, with industrial economies dominated by large firms in oligopolistic markets and well-organized labor unions, prices and wages were much less flexible. As a result, attempts to bring the economy back into balance by reducing wages and prices largely failed. Even when prototypical adjustment succeeded, in the new conditions it created a vicious circle that Irving Fisher called "debt deflation," in which deflation raised real debt burdens, which caused further bankruptcies and further deflation (Fisher 1933). Attempts to hew to gold standard orthodoxy simply worsened the downward spiral—and often heightened political tensions.

The new political realities of the industrial world also affected responses to the crisis that began in 1929. Governments could no longer ignore the impact of the crisis, or of austerity measures, on farmers, the middle classes, and the working classes, for these groups were now well represented in national politics. Attempts to fit national economies to their international commitments ran into powerful political opposition and often ended with the toppling of the government that tried to do so, whether by democratic or authoritarian means.

The result almost everywhere was a turn inward in trade, finance, and investment. In Southern, Central, and Eastern Europe, Japan, and Latin America, governments imposed high trade barriers, defaulted on their foreign debts, left the gold standard, and slapped on capital controls. Governments in these nations also typically began to play a more directive role in economic affairs, sometimes nationalizing large portions of the economy. The Soviet Union, which had jettisoned capitalism in 1917 but permitted some aspects of a market economy to persist, shut down these vestiges and embarked on a forced march toward industrialization under central planning. The order of the day was autarky—a classical Greek term recoined to mean a purposive economic policy of national self-sufficiency: trade protection, capital controls, an inconvertible currency. This was usually carried out by an authoritarian government—fascist in Central and Eastern Europe, communist in the Soviet Union, nationalist in Latin America—as almost all the preexisting democracies were swept away.

The new autarkic governments changed direction toward heavy-handed intervention in the economy and international economic relations, so much so that the policy was sometimes, and with some justification, called "neomercantilist." Yet developing and semi-industrial countries could hardly be faulted for falling back on their own resources: international trade dropped by two-thirds between 1929 and 1932, international finance was dead in the water, and the gold standard had largely been abandoned by its strongest proponents. The autarkies could, with some reason, argue that their turn inward was driven by the failure of the global capitalist economy.

Most of the principal economic centers had also largely abandoned their international commitments. In 1931, Great Britain left the gold standard, after more than two centuries on it, and so did most of Europe; the United States followed in 1933. Governments everywhere increased trade protection; even formerly free-trade Britain built tariff walls around its empire. Every attempt to cobble together some semblance of cooperation among the major economic powers failed.

It was only late in the 1930s that an alternative to autarky began to emerge in Western Europe and North America. Governments in these areas—which had largely remained democratic amid the flowering of authoritarianism—expanded their social policies, experimented with countercyclical macroeconomic policies, and gradually increased the role of the public sector. The new model, which eventually gave rise to the modern social democratic welfare state, attempted to blend markets with regulation, an open economy with social insurance. The governments involved also, by 1936, were recommitting themselves to international cooperation in commercial and monetary affairs, trying to bring down trade barriers and stabilize currencies. These attempts were halting and preliminary, but they pointed the way toward a new economic policy synthesis. General sympathy for a market economy and international economic integration coexisted with substantial government involvement in the economy, especially in macroeconomic management and social policy.

Second Chance: The Bretton Woods System

Even as World War II raged, the Allies planned the postwar economy, hoping not to repeat the experience of the aftermath of World War I. This time around, the United States was committed to both building and sustaining an open international economy—and although there remained plenty of isolationist Americans, postwar governments stayed this course. The result was the first international economic order whose general contours had largely been planned by governments, in this case the U.S. and British governments. Because the final negotiations over the arrangement were held in July 1944 at a resort in Bretton Woods, New Hampshire, it became know as the Bretton Woods System.

The Bretton Woods System reflected a general commitment by the capitalist allies (not the Soviet Union), and eventually by virtually all of the advanced industrial capitalist nations, to an open international economic order. All developed parties to the agreement shared the goal of generally free trade and investment and stable currency values. As the system evolved, the General Agreement on Tariffs and Trade (GATT, eventually succeeded by the World Trade Organization, WTO) oversaw a process of gradual trade liberalization. The International Monetary Fund (IMF) supervised monetary relations among member nations, providing balance of payments financing and encouraging generally stable exchange rates. The International Bank for Reconstruction and Development (IBRD or World Bank) financed long-term infrastructure projects that would facilitate private investment in developing countries. Together, these three Bretton Woods institutions watched over an integrated capitalist world economy, which would avoid the protectionism, financial disarray, and currency volatility of the interwar years. (The Soviet Union and its allies were not included in this system, as they had opted out of international capitalism.)

The Bretton Woods monetary order was centered on the U.S. dollar, fixed to gold at $35 an ounce. Other currencies were fixed to the dollar but could be varied in the event "fundamental disequilibria" (never clearly defined) dictated a devaluation or revaluation. This was meant to provide both the currency stability that had been lacking in the interwar years and the flexibility that had been lacking in the classical era. In this way, it was something of a compromise. Governments were expected to abide by the rules of the balance of payments adjustment game, but not at the expense of important national economic goals.

The Bretton Woods System was replete with this sort of compromise. The system itself was, in the broadest sense, meant to reconcile a national commitment to economic integration with a parallel national commitment to demand management and the social democratic welfare state. These two sets of commitments had largely been seen as inconsistent under the gold standard and during most of the interwar period, but appeared both economically and politically desirable and obtainable by the 1940s.[18] There were other compromises as well. Although trade was liberalized, this was achieved only gradually. Not only that, but agricultural and services trade were not included, the developing countries were exempt, and there were many escape clauses written into the agreements, which allowed governments to impose trade barriers in certain circumstances. The same spirit of gradualism and compromise was clear in financial affairs: although there was a general belief in the desirability of free capital movements, virtually all governments imposed capital controls of one sort or another to manage international payments.

The Bretton Woods System governed relations among the industrialized capitalist economies from the late 1940s until the mid-1970s. Over these twenty-five years, the capitalist world grew more rapidly that it had at any time in history. Real per capita GDP had risen 1.3 percent a year between 1870 and 1913, a rate vastly higher than anything previous seen; after dropping below 1 percent a year in the troubled interwar period, from 1950 to 1973 GDP per capita grew by more than 2.9 percent a year—more than twice as rapidly as during the classical age. This average was brought down by relatively slow growth in the developing world: Western Europe's GDP per person grew by more than 4 percent a year, Japan's by more than 8 percent a year. Even though the developing and noncapitalist worlds largely withdrew from international commerce, world trade overall grew twice as fast as world output.[19] There is little question that this compromise between national macroeconomic management and international economic integration was extraordinarily successful.

The less developed countries (LDCs) of Asia, Africa, and Latin America did somewhat less well. Latin American nations were hit hard by the Great Depression and spent most of the subsequent twenty years building self-sufficient national markets. To some extent, this was forced on them by the Depression, World War II, and postwar reconstruction, all of which limited their foreign economic opportunities. But even after wartime conditions faded, Latin American governments maintained and increased their barriers to trade with the rest of the world. They did permit foreign direct investment by multinational corporations, but their principal policies were associated with what has been called import substituting industrialization (ISI), a systematic attempt to encourage domestic manufacturing to replace previously imported manufactured goods. Governments imposed high trade barriers, subsidized domestic manufacturing, taxed exports, took over large portions of basic industry, and generally biased economic incentives against exports and toward production for the domestic market.

As they decolonized, most of the former European colonies in Africa and Asia followed the Latin American example and pursued ISI. The result was a world largely divided in three parts: the industrialized capitalist nations, gradually increasing economic ties among themselves; the developing capitalist nations, growing quite separately from the world economy; and the centrally planned economies of the communist nations, which rejected most ties with the capitalist world. Each of these three segments of the world economy represented a different mix of state and market, openness and closure. The centrally planned economies rejected both markets and international economic integration. The capitalist LDCs accepted markets domestically, but their governments were deeply involved in their national economies and also cordoned themselves off from the rest of the world. The industrial capitalist countries pursued a modest compromise between state and market at home, and a general if restrained commitment to international economic integration.

From Bretton Woods to Globalization

These three approaches appeared stable for several decades. But over the course of the 1970s, each ran into difficulties. Over the course of the 1980s, all were fundamentally transformed. The result was a more inclusive—indeed, virtually global—and heightened trend toward international economic integration.

The Bretton Woods monetary order was strained by the late 1960s. This was primarily due to divergence between monetary conditions in the rest of the industrial world, on the one hand, and the United States, on the other. U.S. spending on the Vietnam War and expanded social programs were contributing to a higher rate of inflation in the United States than in Europe, which undermined confidence in the dollar. Austerity measures could have brought down inflation and restored confidence, but the U.S. government was reluctant to sacrifice its domestic macroeconomic policy autonomy to maintain the gold–dollar link, even if this link was the centerpiece of the Bretton Woods monetary system. In August 1971, the United

States broke the link and devalued the dollar, ending the Bretton Woods era of fixed but adjustable exchange rates.

Another source of tension in the Bretton Woods system was, ironically, due to its success in rekindling international financial markets. While foreign direct investment had continued through the postwar period, international financial flows had effectively stopped in 1929 and stayed minimal until the 1960s. As macroeconomic stability and economic growth were restored, financial institutions rediscovered foreign operations. By the early 1970s, international financial markets were large and growing, and the increased level of international financial flows helped undermine the fixed exchange rate regime by heightening speculative pressures on some currencies (including the U.S. dollar).

Once the Bretton Woods exchange rate arrangement ended, most major currencies began floating freely against one another. This loosened the previous monetary straitjacket, and a bout of inflationary pressures ensued. On top of this, in 1973 a cartel of oil producing nations (the Organization of Petroleum Exporting Countries or OPEC) quadrupled the price of petroleum, putting further upward pressure on prices. A deep recession in 1973–75 led to an unaccustomed mixture of high unemployment and high inflation—stagflation, as it was called. Inflation continued to rise, aggravated by another round of OPEC oil price increases in 1979–80.

The rebirth of international finance also made foreign lending newly available to developing countries, which had been frozen out of capital markets for forty years, and a burst of LDC borrowing ensued. By the early 1980s, a dozen or so developing countries had accumulated substantial debts to commercial banks in Europe, North America, and Japan.

Macroeconomic difficulties came to a head after 1979. The developed countries began to adopt more contractionary monetary policies to slow the rate of inflation. This led to extremely high interest rates and several years of recession. The spike in interest rates and global recession threw the LDC debtors into a severe debt crisis, which took many of them the better part of the decade to resolve. Meanwhile, while inflation was brought down in the advanced capitalist countries, unemployment remained at very high levels. The centrally planned economies, too, had been experiencing stagnant growth, and their economic and political systems came under ever greater strain.

In this crisis atmosphere, the developed countries gradually moved to recommit themselves to a market orientation and international economic openness. Governments exercised greater monetary restraint, deregulated many economic activities, and privatized previously public enterprises. The trend was epitomized by the policies of British Prime Minister Margaret Thatcher and U.S. President Ronald Reagan, who made the case for less government involvement in their respective economies. Reagan did so, anomalously, while running up enormous budget deficits in the United States. Nonetheless, and despite such setbacks as a costly banking crisis, by the mid-1980s the developed capitalist countries had made clear their reinforced dedication to an integrated international economy.

The developing countries, for their part, emerged from debt and related crises with a new-found orientation toward international markets. To be sure, some few LDCs, especially in East Asia, had been following an export-led strategy, but until the 1980s ISI had been the almost universal policy choice of developing nations. The debt and oil crises, along with the accumulated problems of relatively closed markets in an increasingly open world economy, led almost every country in Latin America, Africa, and Asia to jettison the prior inward orientation in favor of much more economic openness to the rest of the world. Developed and developing capitalist countries continued to reduce barriers to trade and investment, leading to a characterization of the era as one of "globalization."

The most stunning development on the path to globalization was the collapse of the centrally planned economies. The economic problems of the late 1970s and early 1980s eventually drove these countries away from central planning and toward international markets. China and Vietnam were the first to move, in 1979: while maintaining communist rule, both governments reoriented their economies toward exporting to the capitalist world. After 1985, the Soviet Union embarked on an attempt at gradual reform, which was quickly overtaken by events as the country's social and political system unraveled. After the Soviet Union collapsed in 1991, the entire Soviet bloc quickly gave up central planning and moved toward capitalism at speeds varying from gradual to breakneck.

Along with globalization came a renewed interest in regional economic blocs. The European Union (EU) added a whole host of new members, until it encompassed virtually all of Europe. Meanwhile, by 1992 the EU had put in place a single market that eliminated barriers to the movement of goods, capital, and people and that harmonized the regulation of investment, migration, product and production standards, professional licensing, and many other economic activities. A subset of EU members went a step further in 1999, creating a single currency, the euro, and a common European Central Bank. The United States, Canada, and Mexico formed a free trade area in 1994, as did Brazil, Argentina, Uruguay, and Paraguay. All over the world, countries rushed to open their borders, increase their exports, attract foreign capital, and strengthen their economic ties with each other.

By the beginning of the twenty-first century, the modern world economy looked strikingly similar to the classical order of the beginning of the twentieth century. International trade, investment, and finance were generally free from government restrictions. Most governments limited their intervention in markets and in international economic transactions. Migration was less free than it had been, and there was no overarching monetary standard, but otherwise there were many similarities to conditions a century earlier. Capitalism was global, and the globe was capitalist.

Global capitalism had, however, changed profoundly in the intervening years. Today, there is substantial government involvement in the economy, both in macroeconomic demand management and in the provision of a wide array of social insurance and other social programs. This is true of all developed countries and of many developing countries as well. The social democratic welfare state is now the norm rather than a novelty, and despite periodic objections it seems unchallenged as the standard organizational form of a modern capitalist political economy.

Just as contemporary capitalism incorporates substantial government supervision of national economic activities, it is also characterized by a dense network of international institutions. Some are regional, such as the European Union. Many are global, such as the IMF and the WTO. The informal cooperative arrangements of the gold standard era have given way to a much more complex array of formal international organizations.

However successful the contemporary economic order may be, it has not eliminated problems that have plagued capitalism since its beginnings. Foremost among these is the recurrence of periodic crises. A deep recession that began late in 2007 served as a reminder that financial and commercial ties among countries can transmit crises—even panics—from market to market with lightning speed. The crisis of 2007–10 also highlights the role of international financial flows, as it was in large part the result of a decade of very substantial cross-border lending and borrowing (Chinn and Frieden 2011). Financial and currency crises, it seems, are the price of open financial markets.

Although contemporary capitalism has been associated with rapid economic growth in many parts of the world—most strikingly, in communist-ruled China—there are still many parts of the developing world that remain mired in poverty. Whether this is due to excessive or insufficient reliance on markets or excessive or insufficient integration into the world economy remains a topic of hot debate. This is not surprising. It is almost certainly in the nature of capitalist political economies that there will be enduring conflicts over how and how much government should intervene in markets and how tightly and on what terms national economies should be tied to the world economy.

Over the past five centuries, capitalism has gone from being a novel economic system in a small region in Western Europe to being the prevailing form of economic organization in the whole world. The rise and eventual triumph of capitalism on a global scale has been associated with the most rapid economic growth in world history. It has also been associated with spectacular crises, wrenching conflicts, and a great and growing gap between the world's rich and the world's poor. Global capitalism holds out the hope of extraordinary social and economic advances, but it must address its weaknesses to realize these advances.

Notes

1. Rostovtzeff (1960) is the best-known argument for Rome's capitalism. Temin (2006) presents strong evidence for the operation of markets in the Roman empire but does not explicitly consider whether the society should be considered capitalist.
2. Cited in Viner (1948).
3. On a more arcane but still important note, as Keynes pointed out (1936, chapter 23), the mercantilist emphasis on bullion and on a trade surplus served to increase the

money supply (in a specie-based monetary system) and to reduce borrowing costs. In societies heavily oriented toward entrepreneurial activities and novel endeavors, the "shortage of money" (high interest rates) was seen as a major brake on progress. In fact, some of the protectionist measures associated with mercantilism may have been triggered by the emphasis on increasing the money supply to lower interest rates, which would of course also have raised domestic prices.
4. Classic analyses are Ekelund and Tollison (1981) and Ekelund and Tollison (1997).
5. Smith (1776, Book Four).
6. For the definitive analysis, see Schonhardt-Bailey (2006).
7. The remainder of this essay draws loosely on material in Frieden (2006). See that reference for many more details.
8. Maddison (1995, p. 64).
9. Stamp (1979); Mathias and Pollard (1989, p. 56); Maddison (2001, p. 95).
10. Maddison (1995, p. 38). For an excellent survey of the period, see Marsh (1999).
11. O'Rourke and Williamson (1999, p. 209).
12. See, for example, Estevadeordal et al. (2003) and López-Córdova and Meissner (2003).
13. Bordo and Rockoff (1996, pp. 389–428).
14. Eichengreen (1992); Eichengreen and Flandreau (1997). The presentation here is greatly simplified. Governments generally tried to manage their economies so as to avoid major gold flows. This could involve trying to retain gold by raising interest rates, which would tend to keep money at home to take advantage of the higher rate of return. Or it could involve trying to brake domestic wages, prices, and profits, so as to make exports more competitive. Nonetheless, these policies had their origin in the pressures that being on gold exerted on national economies and national governments.
15. O'Rourke and Williamson (1999, pp. 43–53). See also Capie (1983).
16. The classic summary of the technological aspects of the process is Landes (1969, pp. 231–358).
17. Eichengreen (1992) is the canonical analysis of the period.
18. uggie (1982) is the classic statement of the argument.
19. Maddison (2001).

References

Bordo, Michael, and Hugh Rockoff. "The Gold Standard as a 'Good Housekeeping Seal of Approval.'" Journal of Economic History 56 (June 1996): 389–428.

Capie, Forrest, H. "Tariff Protection and Economic Performance in the Nineteenth Century." In Policy and Performance in International Trade, ed. John Black and L. Alan Winters1-24. London: Macmillan, 1983.

Chinn, Menzie, and Jeffry Frieden. Lost Decades: □ e Making of America's Debt Crisis and the Long Recovery. New York: Norton, 2011.

Eichengreen, Barry. Golden Fetters: □ e Gold Standard and the Great Depression, 1919–1939. New York: Oxford University Press, 1992.

Eichengreen, Barry, and Marc Flandreau, eds. □ e Gold Standard in □ eory and History. New York: Routledge, 1997.

Ekelund, Robert B., and Robert D. Tollison. Mercantilism as a Rent-Seeking Society. College Station: Texas A&M University Press, 1981.

Ekelund, Robert B., and Robert D. Tollison. Politicized Economies: Monarchy, Monopoly, and Mercantilism. College Station: Texas A&M University Press, 1997.

Estevadeordal, Antoni, Brian Frantz, and Alan M. Taylor. "The Rise and Fall of World Trade, 1870–1939." Quarterly Journal of Economics 118 (May 2003): 359–407.

Fisher, Irving. "The Debt-Deflation Theory of Great Depressions." Econometrica 1 (Oct. 1933): 337–357.

Frieden, Jeffry. Global Capitalism: Its Fall and Rise in the Twentieth Century. New York: Norton, 2006.

Hochschild, Adam. King Leopold's Ghost. Boston: Houghton Mifflin, 1998.

Keynes, John Maynard. The General Theory of Employment, Interest and Money. London: Macmillan, 1936.

Landes, David. The Unbound Prometheus: Technological Change and Industrial Development in Western Europe from 1750 to the Present. Cambridge: Cambridge University Press, 1969.

López-Córdova, J. Ernesto, and Christopher M. Meissner, 2003. "Exchange-Rate Regimes and International Trade: Evidence from the Classical Gold Standard Era." American Economic Review 93 (March 2003): 344–353.

Maddison, Angus. Monitoring the World Economy 1820–1992. Paris: OECD, 1995.

Maddison, Angus. The World Economy: A Millennial Perspective. Paris: OECD, 2001.

Marsh, Peter. Bargaining on Europe: Britain and the First Common Market 1860–1892. New Haven, Conn.: Yale University Press, 1999.

Mathias, Peter, and Sydney Pollard. "European Trade Policy, 1815–1914." In The Cambridge Economic History of Europe (vol. 8): The Industrial Economies: The Development of Economic and Social Policies, ed. Peter Mathias and Sidney Pollard, 1–160. Cambridge: Cambridge University Press, 1989.

O'Rourke, Kevin, and Jeffrey Williamson. Globalization and History: The Evolution of a Nineteenth-Century Atlantic Economy. Cambridge, Mass.: MIT Press, 1999.

Rostovtzeff, Mikhail. Rome. New York: Oxford University Press, 1960.

Ruggie, John G. "International Regimes, Transactions, and Change: Embedded Liberalism in the Postwar Economic Order." International Organization 36 (March 1982): 379–415.

Schonhardt-Bailey, Cheryl. From the Corn Laws to Free Trade: Interests, Ideas and Institutions in Historical Perspective. Cambridge, Mass.: MIT Press, 2006.

Smith, Adam. An Inquiry into the Nature and Causes of the Wealth of Nations. New York: Modern Library, 1937 (1776).

Stamp, A. H. A Social and Economic History of England from 1700 to 1970. London: Research Publishing, 1979.

Temin, Peter. "The Economy of the Early Roman Empire." Journal of Economic Perspectives 20 (Winter 2006): 133–151.

Viner, Jacob. "Power versus Plenty as Objectives of Foreign Policy in the Seventeenth and Eighteenth Centuries." World Politics 1 (Oct. 1948): 1–29.

WS

* *Introduction* *

THE FRAGILE GLOBAL ECONOMY

CAPITALISM is the most successful wealth-creating economic system that the world has ever known; no other system, as the distinguished economist Joseph Schumpeter pointed out, has benefited "the common people" as much. Capitalism, he observed, creates wealth through advancing continuously to ever higher levels of productivity and technological sophistication; this process requires that the "old" be destroyed before the "new" can take over. Technological progress, the ultimate driving force of capitalism, requires the continuous discarding of obsolete factories, economic sectors, and even human skills. The system rewards the adaptable and the efficient; it punishes the redundant and the less productive.

This "process of creative destruction," to use Schumpeter's term, produces many winners but also many losers, at least in the short term, and poses a serious threat to traditional social values, beliefs, and institutions. Moreover, the advance of capitalism is accompanied by periodic recessions and downturns that can wreak havoc in peoples' lives. Although capitalism eventually distributes wealth more equally than any other known economic system, as it does tend to reward the most efficient and productive, it tends to concentrate wealth, power, and economic activities. Threatened individuals, groups, or nations constitute an ever-present force that could overthrow or at least significantly disrupt the capitalist system.

Revolt in the international system against a global economy characterized by open markets, unrestricted capital flows, and the activities of multinational firms appears repeatedly in the guise of trade protection, closed economic blocs, and various kinds of cheating. Individual nations and powerful groups within nations that believe the world economy functions unfairly and to their disadvantage, or who wish to change the system to benefit themselves to the detriment of others, are an ever-present threat to the stability of the system.

The international capitalist system could not possibly survive without strong and wise leadership. International leadership must promote

international cooperation to establish and enforce rules regulating trade, foreign investment, and international monetary affairs. But it is equally important that leadership ensure at least minimal safeguards for the inevitable losers from market forces and from the process of creative destruction; those who lose must at least believe that the system functions fairly. Continuation of the market or capitalist system will remain in jeopardy unless considerations of efficiency are counterbalanced by social protection for the economically weak and training/education of those workers left behind by rapid economic and technological change.

With the 1989 end of the Cold War, many proclaimed the "triumph of global capitalism," and by the late-1990s, the American people were enjoying what *The Economist* of London called the "longest-ever . . . economic expansion." Unemployment (about 4 percent) was the lowest in almost thirty years, wages were up for most American workers, and inflation was low; this was indeed an economic achievement. The performance of the stock market was extraordinary as the Dow Jones index broke through the 10,000 mark in the spring of 1999; the "wealth effect" of the high stock market, which encouraged Americans to spend freely, draw down their personal savings, and go deeply into debt, fueled rapid economic growth. With the rest of the world in recession or other dire economic straits, many Americans believed that the United States in the 1990s had fashioned a new type of capitalist economy and had escaped forever from ills historically associated with the capitalist system.

Chapter 1

This New American Economy (NAE), many declared, had been created by several important developments, including the freeing of markets from excessive government regulations, downsizing and restructuring of American corporations, and rapid technological advances (especially the computer, information technologies, and the Internet). Moreover, economic globalization, high rates of productivity growth, and the openness of the American economy to imports had kept prices down and dampened inflationary pressures, thereby allowing the Federal Reserve (America's central bank) to pursue expansionary economic policies. Moreover, reduction of the federal budget deficit, superior business management, and reinvigorated American entrepreneurship had made the American economy better suited than its Japanese and European competitors to take advantage of the Internet economy and

the inevitable shift of the advanced economies from manufacturing to service industries. These developments had greatly increased the international competitiveness of the American economy.

Enthusiastic supporters of the NAE even proclaimed that the American economy had transcended the "boom and bust" of the business cycle that has historically plagued capitalist economies. It seemed that the economic boom could continue forever. Most academic economists, on the other hand, were skeptical of such claims and warned that the American economy was experiencing a "speculative bubble." Like the Japanese bubble of the late 1980s and similar bubbles of the past, the American bubble would also necessarily burst one day.

Rejoicing in their own good fortune, Americans failed to appreciate that the country's prosperity was highly dependent on the global economy and that, in international economic affairs as in other aspects of life, no person or country is an island. Few appeared to be aware that, although global capitalism had indeed triumphed, the larger global economy was in serious trouble. Nor were they concerned that the Clinton Administration and the Congress were doing very little about it. However, rapid U.S. economic growth throughout much of the 1990s was significantly assisted by exports to overseas markets and also by large amounts of imported capital as well as by inexpensive imports. The United States is one of the world's largest exporters, and long-term economic progress is dependent on these exports. Many American workers benefit greatly from the export economy because exports are associated with higher paying jobs. With the lowest rate of personal savings in the industrialized world, the American economy has also become very dependent on capital imports, and it prospered in the 1990s in part because foreign investors were contributing significantly to financing the American stock market and thus to economic growth.

Although the changes associated with the NAE provide part of the explanation of America's good economic fortune in the 1990s, equally important contributing factors included skillful management of the economy by the Federal Reserve under the chairmanship of Alan Greenspan and just plain good luck. And the United States benefited from highly favorable international developments. The victory over inflation and low interest rates was due in large part to the fact that the rest of the world economy was experiencing slow growth or recession

throughout much of the 1990s; this situation led to lower import prices, especially for petroleum, other raw materials, and consumer goods. For the same reason, the United States has been able to import huge amounts of capital on highly favorable terms; with few other places to invest their capital, both American and foreign investors inflated the American stock market or purchased Treasury bills. As Greenspan has warned, the resultant accumulation of foreign debt could cause the dollar to fall significantly and cannot continue forever.

Resumption of economic growth in Europe and Asia would lessen these favorable conditions and, in the short term, would slow U.S. economic growth, even though over the longer term a revival of global economic growth would immensely benefit American exports. Furthermore, it is not clear that the revival of productivity in the late 1990s can be sustained. During the Reagan boom of the early 1980s, a similar jump in productivity occurred; that boom dissipated by the end of the decade. The increase in productivity in the 1990s could be due to the fact that Americans have been working harder and longer during the boom years rather than be a consequence of the computer and information economy.

Throughout the 1980s and 1990s, America's trade/payments deficits reached record highs. Since the early 1980s, in fact, Americans have borrowed approximately $5 trillion from the savers of the world, especially the Japanese, to finance their consumption and investment. In the mid-1980s, the United States went from its post–World War I position as the world's largest creditor nation to become its largest debtor. If one discounts American investment overseas, the net American international debt in the late 1990s stood at approximately $1 trillion; as a consequence, a sizable portion of the federal budget must be devoted to interest payments on this huge and increasing debt. Furthermore, throughout the 1990s, Americans had emptied their personal savings accounts to fuel "seven years of good times," leaving too little for the "seven years of bad times" that many and perhaps most economists believe loom ahead; the spending spree left 20 percent of American households net debtors. And the "good times" of the 1990s left many behind as the income of the least skilled lagged.[1] Americans appeared to be unaware that one day the nation's huge accumulated debt will

have to be repaid and serious adjustments in the American standard of living will be necessary.

If Japan, Western Europe, and the "emerging" markets of East Asia had also grown rapidly throughout the 1990s, world commodity prices (e.g., for oil, food, and raw materials) would have soared and increased inflationary pressures, and thus would have dampened American economic growth. However, America's unprecedented good economic fortune will one day run out, and when it does the United States must confront its low personal savings rate, deteriorating education system, and accumulated foreign debt, and it must also adjust to a rapidly changing global economy characterized by intensifying competition, exclusive regional arrangements, and an unstable international financial system. The developments transforming the global economy pose a significant challenge to the United States.

Propelled by a number of political, economic, and technological developments, the world has moved from the sharply divided international economy of the Cold War to an increasingly integrated global capitalist economy. The end of the Cold War in 1989 and the subsequent disintegration of the Soviet empire were, of course, extremely important to this change. The rapid industrialization in the 1980s and 1990s of the emerging markets of East Asia, Latin America, and elsewhere shifted global economic power and created an increasingly competitive international economy. Furthermore, the continuing technological revolution associated with the computer and the emergence of the information economy accelerated the shift of the advanced industrialized countries from manufacturing-based toward service-based economies. Enormous increases in international trade, financial flows, and the activities of multinational corporations integrated more and more economies into the global economic system in a process now familiarly known as "globalization." However, by the end of the decade these developments had also produced upheaval in both domestic and international affairs.

The global economic turmoil of the late 1990s, which began in Thailand in July 1997, reflected the growing impact of global economic forces on international economic and political affairs. Spreading quickly throughout the industrializing economies of Pacific Asia,

and even to Japan (already afflicted by serious economic and political troubles), this turmoil soon engulfed much of the world. By the fall of 1998, a quarter of the world economy, including that of Japan, which is the world's second-largest economy, was in recession. Evaporation of wealth in Pacific Asia and elsewhere was enormous, and commodity-exporting countries, including the United States, suffered huge losses as their export markets dried up. Although the Russian economy constituted only a small portion of the international economy and its troubles were largely of its own making, disturbing economic news from Russia in the late summer of 1998 roiled international financial markets, and a large drop in the American and other national stock markets followed. The psychological impact of these developments caused worried investors to withdraw from Brazil and other emerging markets.

Whereas the emerging markets had been hailed in the early 1990s as a source of huge profits for American investors, by the end of the decade they were considered a major source of global economic and political instability. In the 1980s, it would have been unthinkable that a financial crisis originating in a minor Southeast Asian economy could bring harm not only to the United States but also to the rest of the world. Indeed, during the Reagan and Bush Administrations (1981–1993), the United States had been celebrated as the only true superpower; President Bush (following victory in the Gulf War) proclaimed the "New World Order" of peace, prosperity, and democracy with, of course, the United States at its core. A decade later, however, serious doubts had arisen about the prospects for a prosperous and peaceful new world order based on American leadership.

At the beginning of the twenty-first century, the increasingly open global economy is threatened. Although the East Asian and global financial troubles have significantly moderated, the vulnerability of the international financial and monetary system threatens the stability of the global economy; although financial crises appear to be an inherent feature of international capitalism, only half-hearted measures have been taken to prevent future financial crises. In addition, the unity and integration of the global economy are increasingly challenged by the spread of regional economic arrangements; both the European movement toward greater economic and political unity and the North American Free Trade Agreement (NAFTA) represent important shifts away

He's state centric

from an open global economy. And, most important of all, the political foundations of the international economy have been seriously undermined since the end of the Cold War.

Even though the globe has become increasingly integrated both economically and technologically, it continues to be politically fragmented among independent, self-interested states. The forces of economic globalization—trade, financial flows, the activities of multinational corporations—have made the international economy much more interdependent. At the same time, the end of the Cold War and the decreased need for close cooperation among the United States, Western Europe, and Japan have significantly weakened the political bonds that have held the international economy together. As a consequence, the rule-based international economic system laid down at the Bretton Woods Conference (1944) has greatly eroded. Despite some important reforms, including the 1995 creation of the World Trade Organization (WTO), the rules governing trade, money, and other international economic matters are no longer adequate for a highly integrated and fragile global economy.

The problems arising from increased economic integration of national economies necessitate new rules or modification of older rules to deal with pressing economic issues and ensure the continued existence of an open and stable global economy. The international integration of financial markets, the increasing importance of multinational corporations and foreign direct investment, and the spread of regional economic blocs call for action by the major powers and the rising economies of East Asia and elsewhere. Continuing failure of the international community to address crucial international economic matters threatens the stability of the global economy. Improved governance and management have become imperative.

Atrophy of the political cooperation that characterized the post–World War II international economic order has undermined the foundations of that order. A stable and prosperous international economy (like a domestic economy) requires strong and stable political foundations to undergird the institutions and rules governing the system and to prevent problems from escalating into crises like the post-1997 financial crisis. Strong international leadership, cooperative relations among major economic powers, and a commitment by citizens to an

open world are all crucial elements. From 1945 to the 1980s, strong and generally prudent American leadership, close cooperation among the United States and its major allies, and a domestic consensus in the major capitalist economies favoring free trade and an open world economy provided a firm base for the development of the integrated international economy. However, the foundations first laid down at Bretton Woods have been weakened as have the shared political interests, mutual understandings, and cooperative arrangements of the Cold War decades.

By the beginning of the twenty-first century, American leadership of the world economy had been significantly weakened by a number of developments. The faltering domestic consensus on economic affairs contributed to that decline. Whereas, during most of the Cold War, the federal government had been expected to assume an important role in management of both domestic and international economic affairs, the market became ascendant with the presidency of Ronald Reagan, and many began to believe that the market alone could govern the world. The end of the Cold War has undermined America's ability and willingness to pay the economic and other costs of world economic leadership. Throughout the Cold War, Americans believed that partisan political concerns and other divisive issues should be set aside in the interest of national unity in foreign affairs; collapse of the Soviet threat greatly weakened this belief. In the economic realm, the American domestic consensus supporting free trade was weakened by ideological and political schisms regarding economic policy and by growing fears that economic globalization was threatening American economic well-being.

In the 1990s, many constituencies in the United States protested expansion of trade and foreign investment, arguing that they harmed the American worker, the environment, and human rights. Simultaneously, more and more Americans attributed the country's economic and other problems to globalization, and accused imports and corporate investments overseas of hurting American workers, small businesses, and the overall society. Many, for example, began to believe that increased economic inequality, declining real wages, and increasing job insecurity had been caused by increased competition from Mexico, Pacific Asia, and other low-wage economies. This shift in thinking was well illustrated by the acrimonious 1997 debate over and the failure

of Congress to approve "fast track" authority to facilitate new trade negotiations, and by the lengthy 1998 delay of congressional approval of an appropriation ($18 billion) for the International Monetary Fund (IMF).[2] Attacks from both the political right and left on the evils of the global economy have become symptomatic of America's retreat from international leadership.

Since the end of the Cold War, economic cooperation among the United States and its allies has eroded considerably, and American foreign and economic policy has become more unilateral and self-centered. This shift away from international cooperation began in the mid-1980s when the Reagan Administration abandoned the postwar commitment to economic multilateralism in favor of a "multitrack" trade policy that included managed trade and NAFTA; the United States became converted to economic regionalism. The Clinton Administration's aggressive economic offensive against Japan in the early 1990s underscored America's abandonment of multilateralism and of its prior emphasis on international cooperation with its Cold War allies. The Administration's "managed trade" policy toward Japan would never have been launched during the height of the Cold War.

Meanwhile, the Europeans also became much more parochial in their economic and political concerns than in the past. Their energies have been focused on intensified efforts to create a European economy and polity. They have wanted to stabilize the Continent politically, create a globally competitive European economy, and strengthen their economic and political position vis-à-vis the United States and, to a lesser extent, Japan. Led by the French-German economic alliance, the West Europeans have concentrated on achieving economic unification of the Continent and strengthening the European Union.

The Japanese have also reoriented their economic and foreign policies. Following the 1985 Plaza Agreement and the consequent substantial appreciation of the yen, the Japanese political and economic elite increased their attention to Pacific Asia, and renewed interest in the region led to efforts to fashion a regional economy tightly linked to Japan. Japanese multinational corporations, strongly backed by the Japanese government, created integrated production networks of Japanese and local firms to strengthen the competitiveness of Japanese firms in the global economy. Although this effort has been set back by the East

Asian financial crisis and Japan's own economic problems, the concerted effort to forge a Japanese-led Pacific Asian economy has continued and signifies Japan's increasing assertiveness and independent stance within the global economy.

Failure of the major capitalist powers to launch any coordinated effort to deal with the post-1997 instability in international financial markets revealed the extent to which international cooperation had receded. The weakness of American leadership was painfully evident in President Clinton's speech at the Council on Foreign Relations on September 14, 1998, and in subsequent discussions among the major economic powers (G-7) following the October 1998 annual joint meeting of the World Bank and International Monetary Fund. The centerpiece of the President's Council speech—a proposal for a global cut in interest rates—met a cool reception. The Bundesbank, more concerned with fighting inflation than with the health of the global economy, turned the President's proposal aside; Japan, with nearly zero percent interest rates already and weighed down by its own enormous troubles, appeared to do little to stimulate its economy. Although agreement to create a new loan fund in the IMF was reached by the G-7, there has thus far been inadequate progress in safeguarding international financial matters.

Many political leaders, business executives, and scholars, especially in the United States, dismiss concerns about the future of global capitalism. The world economy, they point out, has become market dominated, and free markets can successfully guide the global economy to ever higher levels of prosperity and stability. According to this argument, the failure of the former command economies and the closed economies of the less developed countries caused governments everywhere to turn toward market solutions to economic problems. Among developed countries, deregulation, privatization, and other reforms have reduced the role of the state in the economy and have led many to proclaim the triumph of international capitalism and the economic ideas on which it rests. This belief in the secure victory of liberated capitalism may turn out to be valid, but it is important to recall that the world passed this way once before in the laissez-faire era prior to the outbreak of World War I and the subsequent collapse of that highly integrated world economy. Although the threat of another major war is very small, other developments could bring down or at least seriously

damage the contemporary international capitalist system. As the revolt against globalization in the United States and other countries reminds us, capitalism creates its own internal enemies.

Throughout this book I shall argue that international politics significantly affects the nature and dynamics of the international economy. Although technological advance and the interplay of market forces provide sufficient causes for increasing integration of the world economy, the supportive policies of powerful states and cooperative relationships among these states constitute the necessary political foundations for a stable and unified world economy. The international rules (regimes) that govern international economic affairs cannot succeed unless they are supported by a strong political base.

Since the end of the Cold War, all the political elements that have supported an open global economy have considerably weakened. Both the ability and the willingness of the United States to lead have declined, and although the formal framework of anti-Soviet alliances has continued, the Cold War allies' political unity has eroded as the United States, Western Europe, and Japan have emphasized their own parochial national and regional priorities more than in the past. Furthermore, the domestic consensus in both the United States and Europe has been worn away by years of increased income inequalities, job insecurity in the United States, and high levels of unemployment in Western Europe. Although major structural changes driven by technological change and ill-considered national policies carry a large share of responsibility for these social and economic ills, more and more people in the United States and Europe blame globalization and competition from foreign low-wage labor. Growing concern over economic globalization and increased competition have intensified the movement toward economic regionalism and the appeal of protectionism.

A number of books proclaim that, whether we like it or not, global capitalism and economic globalization are here to stay. Unfettered markets, they argue, now drive the world and all must adjust, however painful this may be. Yet, as I argue, despite the huge benefits of free trade and other aspects of the global economy, an open and integrated global economy is neither as extensive and inexorable nor as irreversible as many assume. Global capitalism and economic globalization have rested and must continue to rest on a secure political foundation.

across the globe. The big challenge, it concludes, is to reconcile a world divided into states of hugely unequal capacities with exploitation of the opportunities for convergence offered by international economic integration. In short, if we want a better world, we need not a different economics, but better politics.

Edouard Balladur was wrong. The market is not a jungle, but among the most sophisticated products of civilization. It requires for its successful working a complex mixture of constraints, both internal and external to the market itself.[22] The most dangerous jungle is politics. It is there, above all, that we must focus our efforts.

WS

Chapter 2 What Liberal Globalization Means

A 'neo' is someone who pretends to be something, someone who is at the same time inside and outside of something; it is an elusive hybrid, a straw man set up without ever identifying a specific value, idea, regime or doctrine. To say 'neoliberal' is the same as saying 'semiliberal' or 'pseudoliberal'. It is pure nonsense. Either one is in favor of liberty or against it, but one cannot be semi-in-favour or pseudo-in-favour of liberty, just as one cannot be 'semipregnant', 'semiliving', or 'semidead'.

Mario Vargas Llosa[1]

Globalization is a hideous word of obscure meaning, coined in the 1960s, that came into ever-greater vogue in the 1990s.[2] For many of its proponents it is an irresistible and desirable force sweeping away frontiers, overturning despotic governments, undermining taxation, liberating individuals and enriching all it touches. For many of its opponents it is a no less irresistible force, but undesirable. With the prefixes 'neo-liberal' or 'corporate', globalization is condemned as a malign force that impoverishes the masses, destroys cultures, undermines democracy, imposes Americanization, lays waste the welfare state, ruins the environment and enthrones greed. Many of these beliefs are wrong. Globalization is, on balance, resistible. But globalization is also, on balance, highly desirable. Precisely how desirable depends on the choices that are made.

Before trying to elucidate these propositions, one must start by defining what we mean by globalization. This is no trivial task. For, as Paul Hirst of Birkbeck College and Grahame Thompson of the Open University note, 'globalization has become the new grand narrative of the social sciences. We say this less out of any commitment to the sensibilities of postmodernism – we have none – than because we feel the concept offers more than it can deliver.'[3]

The works of third-way theorists, such as Anthony Giddens, adviser to Tony Blair, the British prime minister, fall into this trap. For Professor Giddens, globalization is an irresistible force, transforming all aspects of contemporary society, politics and the economy.[4] Globalization, thus defined, becomes unmanageably broad. It becomes, as Professors Hirst and Thompson remark, a catchphrase for 'often very different cultural, economic and social processes'.[5]

We can avoid these murky waters, for this book has a narrower focus, in economics. This is not only because the economics of globalization are important in themselves, but because they are the driving force for almost everything else.

Defining liberal globalization

What then might be meant by economic globalization? The simplest of all definitions comes from Anne Krueger, the first deputy managing director of the International Monetary Fund. In the John Bonython lecture, delivered in Australia in 2000, she defined globalization as: 'a phenomenon by which economic agents in any given part of the world are much more affected by events elsewhere in the world' than before.[6] There is, however, another more technically precise version of this process: the integration of economic activities, across borders, through markets. Thus, David Henderson, former chief economist of the Organization for Economic Co-operation and Development, defines globalization as: free movement of goods, services, labour and capital, thereby creating a single market in inputs and outputs; and full national treatment for foreign investors (and nationals working abroad) so that, economically speaking, there are no foreigners.[7]

A related definition is offered by Brink Lindsey of Washington's Cato Institute, in his book *Against the Dead Hand*. There, Lindsey defines the word:

> in three distinct but interrelated senses: first, to describe the economic phenomenon of increasing integration of markets across political boundaries (whether due to political or technological causes); second, to describe the strictly political phenomenon of falling government-imposed barriers to international flows of goods, services, and capital; and, finally, to describe the much broader political phenomenon of the global spread of market-oriented policies in both the domestic and international spheres. Since I contend that globalization in the first sense is due primarily to globalization in the second sense, and that globalization in the second sense is primarily due to globalization in the third sense, I do not think it unduly confusing to use the same word to mean three different things.[8]

This is a useful definition of the kind of globalization – let us call it 'liberal globalization' – the protesters condemn. It clarifies its elements in a relatively precise manner. And it does so by showing that what we are talking about is *movement in the direction of greater integration*, as both natural and man-made barriers to international economic exchange continue to fall. A necessary consequence of such a process of integration is the increased impact of economic changes in one part of the world on what happens in the others.

The process of economic integration discussed here could have two conceivable end points. In one, technology remains roughly as it is today, but there are no policy barriers whatsoever to the movement of goods, services, information, capital or people. For reasons of history, the world would still contain distinct cultures and languages, and different legal systems. These would add to the barriers that distance and difficulties of communication continued to impose. Companies would still tend to be national or multinational, not global. The political preconditions for such a global economy could be either the unilateral abolition of barriers by what remained sovereign states, a structure of restricted national sovereignty, similar to that of today's EU members, or a global federation. In other words, a globalized economy, so defined, could be combined with a number of different structures for global governance. This form of integration is conceivable, though it is immensely far from where we are today. We are most unlikely to get there this century, let alone the next decade.

A second and much more radical definition of a global economy would be one in which, in addition to the abolition of politically imposed barriers to economic integration, costs of transport and communications were zero. This form of a global economy is conceivable, but practically impossible. In this world distance would no longer matter. It would be the end of geography. There would no longer be services that are intrinsically non-tradable, such as haircuts, hospital operations and looking after children or old people. The world would be like London or New York today, with almost every conceivable culture effectively cheek by jowl. Economically, the world would be reduced to a point, something that cyberspace has come close to achieving; but only for information.

The value of this more extreme thought-experiment lies in forcing us to appreciate the abiding and enormous importance of costs of transport and

communications. While these costs may continue to fall, they will never come close to zero, except for things that can be completely dematerialized – essentially information. If people want to participate fully in Swedish culture, enjoy a wide choice of Swedish schools for their children, have predominantly Swedish neighbours and partake of the full range of benefits offered by the Swedish welfare state, then they have to live in Sweden. Again, most people will continue to work or go to school within a relatively modest radius of where they live. This would remain true even if all policy barriers to movement of goods, services, capital, information and people were eliminated. Indeed, as the share of services in consumption and gross domestic product rises, geography may come to matter more and more, not less and less.

The point is that distance will always matter, because we are physical. Because distance always matters, so does space. Because space always matters, so does territorial control. Because territorial control matters, so do states. For this simple reason, economic processes will not compel the death of states, unless a state is expunged, whether voluntarily (as in a decision to merge with some other state or states) or forcibly (as in conquest). Indeed, the policies and capacities of states remain central to any understanding of how economic globalization works.

Against technological determinism

Some authors write as if technology were decisive for globalization on its own. The most influential author to come close to this line is Thomas Friedman, foreign affairs columnist for the *New York Times*, in his lively and illuminating book *The Lexus and the Olive Tree*.[9] He defines three democratizations – of technology, information and finance. Behind all three is an unquestioned technological revolution, namely, the immense increase in our capacity to communicate and access information, symbolized by the mobile phone and the Internet. Because of the three democratizations, argues Friedman, traditional top-down organizations – companies and governments – are vulnerable to 'Microchip Immune Deficiency Syndrome'. This:

> is the defining political disease of the globalization era. It can strike any company or country, large or small, East or West, North or South. . . . MIDS is usually contracted by countries and companies that fail to inoculate themselves against changes brought about by the microchip, and the democratizations of technology, finance and information. . . . The only known cure for countries or companies with MIDS is 'the fourth democratization'. This is the democratization of decision-making and information flows, and the deconcentration of power, in ways that allow more people in a country or company to share knowledge, experiment and innovate faster. . . . MIDS can be fatal to those companies and countries that do not get appropriate treatment in time.[10]

Technological determinists argue that the only alternatives today are full openness to the world economy or marginalization and poverty. Furthermore, they add, if a country is a little bit open to modern communications, political pressures from a better-informed population will, on their own, force governments to liberalize their economies and democratize their polities. If this were so, liberalization would no longer be an independent policy choice. It would be the necessary consequence of the technological changes of our time. If technology dictated policy, liberalization would be not an option but a destiny.

Technological determinism is not absurd. It is merely exaggerated. The colossal recent falls in the costs of communicating information must have radical effects on economies, by lowering the cost of making transactions and increasing information about available opportunities to transact. The lower the costs of communications, the higher and more ruthlessly enforced policy barriers must be if economies are to remain as closed to flows of information as they used to be. For this reason, technological determinists are right to believe that the innovations of the past one or two decades have made globalization more difficult to prevent.

Yet one must avoid exaggerating what follows. First, it is not the case that complete liberalization must follow the decline in costs of communications. Governments can continue to control movement of physical things if they wish. Indeed, modern technology makes this easier than before. Governments can oversee and regulate the movement of people even more easily; they can impose barriers upon movement of capital, by failing to recognize or enforce contracts with foreigners; and they can limit international flows of services by controlling the convertibility of domestic means of payment into foreign exchange. Whether they will choose to do any of these things is another question.

Second, even if technology did dictate greater liberalization, it would not follow that governments were helpless. This is because even in a liberal world there would remain, as argued above, both costs of transport and communications and cultural obstacles to mobility. The argument that technology dictates liberalization and this, in turn, renders governments helpless before global economic forces is an intellectual swindle used by many left-of-centre

governments to confuse what they choose to do with what they are compelled to do. As Clive Crook of *The Economist* has argued in his survey of globalization, 'when governments claim that globalization ties their hands, because politically it makes their lives easier, they are conning voters and undermining support for economic freedom. Whatever else this may be, it is not good governance.'[11]

On wider aspects of globalization

The definitions above concern only the economic aspects of globalization. Yet changes in technology and the economy also have complex cultural, social and political effects. Changes in how people are able to earn their living, in what they can buy, in how readily they can move from place to place, in how easily they can transport things, in how they can disseminate and access information and ideas necessarily transform human societies and the individual human beings who live within them.

Some scholars have attempted to define such non-economic aspects of globalization relatively precisely. The sociologist Peter Berger, of Boston University, has argued, for example, that there are four facets of cultural globalization: business values – or the impact of 'Davos man', named after the location of the annual meeting of the World Economic Forum; intellectual values – or the influence of the 'faculty club'; popular commercial culture; and the spread of religious movements – particularly evangelical Protestantism, now thought to embrace some 250 million people world-wide.[12] He argues that '[G]lobalization is, *au fond*, a continuation, albeit in an intensified and accelerated form, of the perduring challenge of modernization. On the cultural level, this has been the great challenge of pluralism: the breakdown of taken-for-granted traditions and the opening up of multiple options for beliefs, values and lifestyles. It is not a distortion to say that this amounts to the great challenge of enhanced freedom for both individuals and collectivities.'[13]

Changes in technology and economic policy do have such political, social and cultural effects. How could they not do so? Today, a regime that wants its people to be fully engaged in the global economy cannot prevent them from gaining access to the extraordinary range of information, including that about their own country. This may make despotic regimes unsustainable. But, important though they are, these changes are not part of the definition of

globalization employed here. They are treated, instead, as consequences or concomitants.

Conclusion

Globalization is defined in what follows as integration of economic activities, via markets. The driving forces are technological and policy changes – falling costs of transport and communications and greater reliance on market forces. The economic globalization discussed here has cultural, social and political consequences (and preconditions). But those consequences and preconditions are neither part of its definition nor a focus of our attention.

Week 6

W6

Origins of growth: How state institutions forged during the Protestant Reformation drove development

Jeremiah Dittmar, Ralf R Meisenzahl

26 April 2016

Throughout history, most states have functioned as kleptocracies and not as providers of public goods. This column analyses the diffusion of legal institutions that established Europe's first large-scale experiments in mass public education. These institutions originated in Germany during the Protestant Reformation due to popular political mobilisation, but only in around half of Protestant cities. Cities that formalised these institutions grew faster over the next 200 years, both by attracting and by producing more highly skilled residents.

Jeremiah Dittmar
Professor of Economics, London School of Economics

Ralf R Meisenzahl
Senior Economist, Federal Reserve Board

The state can be a rent-extracting institution or a provider of public goods. What happens when the state *becomes* the provider of public goods?

Recent research suggests that where states have greater capacity to provide public goods, economic outcomes may be superior (Besley and Persson 2009, 2010, Acemoglu et al. 2015). The economics literature has emphasised expansions of state capacity that emerged for geostrategic and military reasons in European history 'from above'.

Related

Media, markets and institutional change: Evidence from the Protestant Reformation
Jeremiah Dittmar, Skipper Seabold

How universities helped transform the medieval world
Davide Cantoni, Noam Yuchtman

Decentralising education: Evidence from the BRICs
Latika Chaudhary, Aldo Musacchio, Steven Nafziger, Se Yan

Wars, plagues, and Europe's rise to riches
Joachim Voth, Nico Voigtländer

In a recent paper (Dittmar and Meisenzahl 2016), we study a unique experiment that shifted legal institutions at the local level – the *institutional public goods programme* of the Protestant Reformation in Germany.

The institutions that we study were city-level laws that established Europe's first large-scale experiments with mass public education and significantly expanded the social welfare bureaucracies and state capacities of cities. These legal institutions established a fundamental innovation in funding and oversight for municipal activities – the 'common chest', a literal box of funds used to support public services. Significantly, the adoption of these institutions reflected popular political mobilisation.

In our research, we study the local variation in institutions and answer three interrelated questions:

- How did these innovations shape development?
- Why did some but not all cities adopt these institutions?
- What was the political process driving these transformations in German society?

Mapping an institutional upheaval

The local adoption of these new legal institutions was highly variable. In fact, fewer than 55% of

Don't Miss

Happiness inequality and the importance of trust
Helliwell

What else can central banks do?
Ball, Gagnon, Honohan, Krogstrup

Brexit: Economic prosperity and voting behaviour
Zoega

Selected takeaways from the ECB Sintra Forum on "The Future of the International Monetary and Financial Architecture"
Constâncio, Hartmann

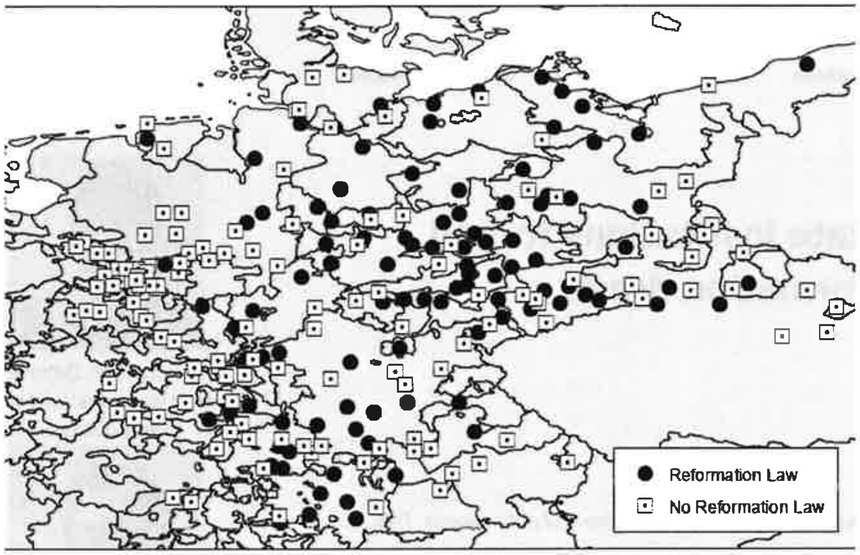
A new eBook: Brexit Beckons
Baldwin

How secular stagnation spreads and how it can be cured
Eggertsson, Summers

The economics of Brexit: Pre-referendum videos and columns
Baldwin

The greatest reshuffle of individual incomes since the Industrial Revolution

Figure 1. The institutional geography that emerged across German cities by the late 1500s



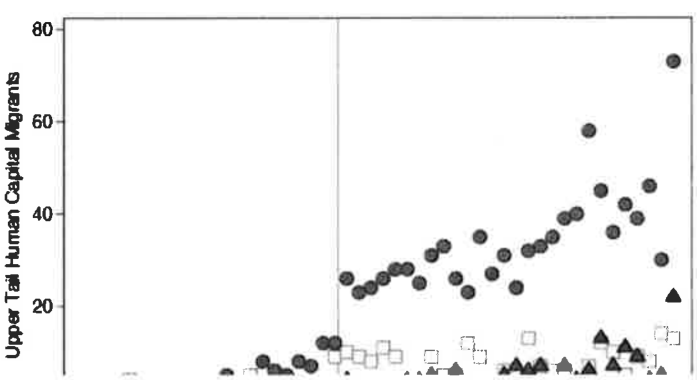
The impact of institutions on long-run development

We test the hypothesis that cities with city-level Reformation laws by 1600 subsequently grew relatively quickly. Our first finding is that cities that adopted the Reformation institutions grew to be at least 25% larger in 1800 than observably similar cities. In contrast, we find no variation in growth associated with Protestant religion conditional on public goods institutions.

Historical evidence suggests that migration drove city growth in pre-industrial Europe (de Vries 1986, Bairoch 1991, Reith 2008). Existing quantitative evidence on migration is limited. We collect novel microdata on the migration and local formation upper tail human capital (Mokyr 1999, Squicciarini and Voigtlander 2015). Our data, drawn from the *Deutsche Biographie*, comprise thousands of the most important cultural and economic figures in German history between 1300 and 1800 – jurists, merchants, writers, artists, composers, and educators. We use the data to document the human capital response to institutional change.

Figure 2 shows how migration responded to institutional change by plotting the number of upper tail human capital migrants observed in cities that adopted public goods laws, cities that became Protestant but did not formalise public goods provision, and Catholic cities. These cities were attracting similarly small numbers of migrants before the Reformation, which is marked by the vertical line at 1518. A large shift in migration towards cities with public goods institutions appears in the 1520s, as legal reforms were passed. This gap persisted over the next 200 years and notably was driven by differences in migration from small towns to cities, *not* by a 'brain drain' from less to more desirable cities.

Figure 2. Response of migration to institutional change



Resiliency Authors

New VoxEU eBook: How to fix the Eurozone
Baldwin, Giavazzi

EZ Crisis: A consensus narrative
Consensus Authors

Most Read

This Month | All Time

Economic growth with stagnating median incomes: New analysis
Nolan, Roser, Thewissen

What else can central banks do?
Ball, Gagnon, Honohan, Krogstrup

Brexit and other harbingers of a return to the dangers of the 1930s
Persaud

Investment and Protectionism: A pre-G20 summit briefing
Evenett, Fritz

Drivers of inequality: Trade versus tax rates
Campbell, Lusher

more

CEPR Policy Research

Discussion Papers | Insights

Homeownership of immigrants in France: selection effects related to international migration flows
Gobillon, Solignac

Climate Change and Long-Run Discount Rates: Evidence from Real Estate
Giglio, Maggiori, Stroebel, Weber

The Permanent Effects of Fiscal Consolidations
Summers, Fatás

Demographics and the Secular Stagnation Hypothesis in Europe
Favero, Galasso

QE and the Bank Lending Channel in the United Kingdom
Butt, Churm, McMahon, Morotz, Schanz

Events

Political Economy of International Organizations
12 - 14 January 2017 / Bern, Switzerland / University of Bern

European Public Choice

We similarly find that cities with public goods institutions began producing more upper tail human capital starting after 1520. We find no differences in the local formation of upper tail human capital before the Reformation and 50-200% higher formation of upper tail human capital after the Reformation when we compare cities with laws supporting public goods provision to cities without these institutions.

Why not all cities adopted public goods institutions

The Protestant Reformation was both a religious revival movement and an anti-corruption movement with an institutional agenda. The institutional agenda was designed to expand the provision of public services.

Popular political mobilisation drove the Protestant Reformation. Local elites and city councils initially resisted the introduction of Protestantism (Cameron 1991, Dickens 1979). Civil disobedience and unrest pushed policymakers to meet citizen demands and pass laws establishing the public goods institutions of the Reformation. Differences in institutional outcomes across municipalities reflected differences in local preferences and in political mobilisation, which varied across cities even within the same territory.

How plague outbreaks shifted politics and institutions

The very features that led some communities to welcome religious innovation and to mobilise in support of institutional change may have had independent implications for economic development.

To untangle cause and effect, we study how plague outbreaks in the critical juncture of the early 1500s shifted local politics and pushed otherwise similar cities towards institutional change.

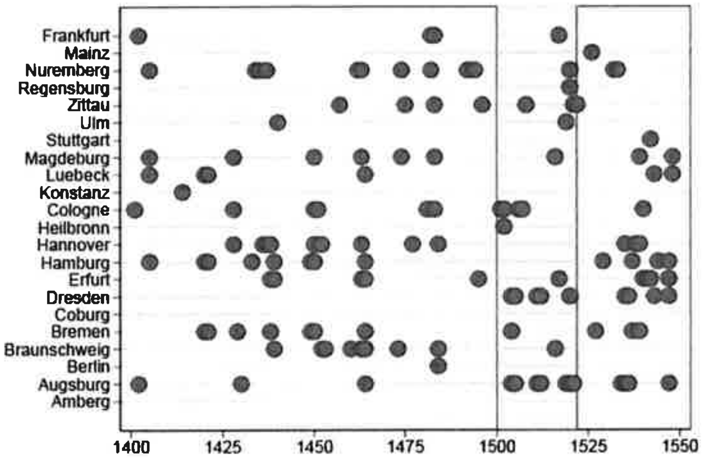
During plague outbreaks incumbent wealthy elites typically fled their home cities or died, reducing their political power (Dinges 1995). Following plague outbreaks, migration into cities increased, changing the composition and politics of the population (Isenmann 2012). During these periods, suffering was acute and civic order could break down. Before the Reformation, plagues led to religious innovations within Catholicism – such as the development of penitential rituals and marches and the construction of church altars to 'plague saints.'

During the Reformation – with the introduction of political and religious competition – plagues suddenly operated as institutional shifters. Plagues operated as institutional shifters not only because they caused extreme suffering, but specifically because Protestants and Catholics were differentiated in the market for religion in their institutional programme and teachings regarding the plague.

We study local plague outbreaks in the early 1500s as a source of plausibly random variation in institutional change. The intuition is that plagues that hit the generation in place when the Reformation broke across German cities were random, conditional on long-run levels and trends. In the data, we find that an additional plague in the early 1500s increased the probability of adopting the new legal institutions by 10-25%.

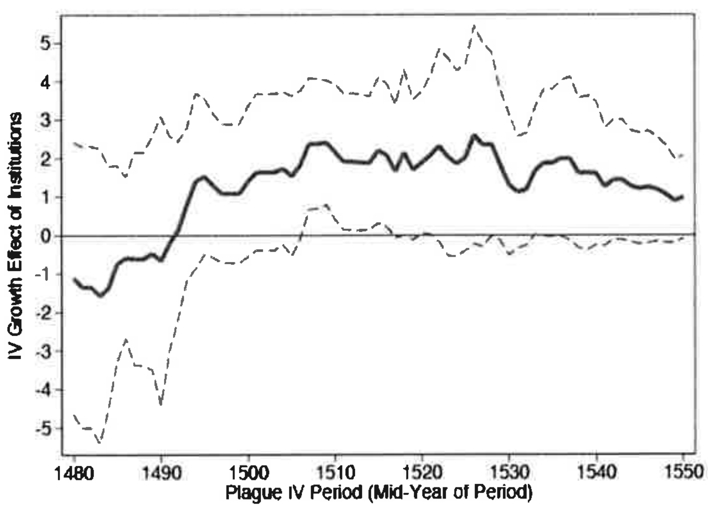
To illustrate the research design, Figure 3 shows the timing of plague outbreaks in select cities. In Figure 3, we highlight the period 1500 to 1522, which serves as the baseline period that we use to study the implications of the plague for institutional change.

Figure 3. Timing of plagues in select cities



To document the unique relationship between plagues in the early 1500s, institutions, and growth, we study plague outbreaks across the entire period from 1400 to 1600. Figure 4 plots the point estimates from rolling instrumental variable (IV) regressions that study log city population in 1800 as the outcome. We estimate these regressions shifting the time period, which we use as the plague exposure IV for institutional change year-by-year. There is no significant relationship between plagues across the 1400s and subsequent institutional change and the 2SLS estimates of the population growth impact of induced variation in institutions are insignificant. In the early 1500s, these relationships change. With the introduction of religious and political competition, we see plague exposure being activated as an institutional shifter with development consequences in the early 1500s.

Figure 4. Plague period and growth of institutions



Conclusion

During the Protestant Reformation, some but not all German cities adopted new municipal legal institutions. These institutions expanded state capacity and established public schooling. The cities that adopted these institutions grew faster over the next 200 years. These cities attracted and produced more upper tail human capital individuals and embarked on more dynamic development trajectories. Cities that adopted Protestantism but did not formalise public goods institutions in law had no similar advantage.

Our results strongly suggest that human capital was not dormant, waiting to be 'activated' during the Industrial Revolution – it was instead a fundamental driver of growth over the early modern period. More broadly, our findings suggest that the Protestant Reformation was a canonical model of the

References

Acemoglu, D, C Garcia-Jimeno and J Robinson (2015) "State capacity and economic development: A network approach", *American Economic Review*, 105: 2364-2409.

Bairoch, P (1991) *Cities and economic development: From the dawn of history to the present,* University of Chicago Press.

Besley, T and T Persson (2009) "The origins of state capacity: Property rights, taxation, and politics", *American Economic Review*, 99: 1218-44.

Besley, T and T Persson (2010) "State capacity, conflict, and development", *Econometrica*, 78: 1-34.

Cameron, E (1991) *The European Reformation*, History Reference Center, Clarendon Press.

De Vries, J (2006) *European Urbanization, 1500-1800*, Routledge.

Dickens, A (1979) "Intellectual and social forces in the German Reformation", in Mommsen, W (ed), *Stadtburgertum und Adel in der Reformation*, Ernst Klett.

Dinges, M (1995) "Pest und Staat: Von der Institutionengeschichte zur Sozialen Konstruktion?", in Dinges, M and T Schilch (eds) *Neue Wege in der Seuchengeschichte*, Franz Steiner, Stuttgart.

Dittmar, J and R Meisenzahl (2016) "State capacity and public goods: Institutional change, human capital, and growth in early modern Germany", Working paper, LSE Centre for Economic Performance and Federal Reserve Board.

Isenmann, E (2012) *Die Deutsche Stadt im Mittelalter 1150-1550*, Bohlau.

Mokyr, J (2009) T*he enlightened economy: An economic history of Britain, 1700-1850*, New Economic History of Britain, Yale University Press.

Reith, R (2008) "Circulation of skilled labour in late medieval Central Europe", in Epstein, S and M Prak (eds) *Guilds, Innovation and the European Economy, 1400-1800*, Cambridge University Press, Cambridge.

Squicciarini, M and N Voigtlander (2015) "Human capital and industrialization: Evidence from the age of Enlightenment', *Quarterly Journal of Economics,* 130: 1825-83.

Topics: Economic history Institutions and economics Politics and economics

Tags: history, protestant reformation, Germany, Enlightenment, education, public education, development, geography, institutions, Public goods

Related

Media, markets and institutional change: Evidence from the Protestant Reformation
Jeremiah Dittmar, Skipper Seabold

How universities helped transform the medieval world
Davide Cantoni, Noam Yuchtman

Decentralising education: Evidence from the BRICs
Latika Chaudhary, Aldo Musacchio, Steven Nafziger, Se Yan

Wars, plagues, and Europe's rise to riches
Joachim Voth, Nico Voigtländer

w6

CHAPTER 5

Post-1945 capitalism: variations across countries

National capitalisms

A COHERENT SET OF INSTITUTIONS and mechanisms were set up after 1945 to regulate capitalism at the international level. This still left substantial room, however, for a number of distinct varieties of national capitalism. In part, this was because the initial design of the Bretton Woods system, with its restrictions on international capital flows, allowed considerable scope for economic policy autonomy at the national level. But the existence of national varieties of capitalism goes well beyond this scope for policy autonomy and reflects wider and more profound differences in the practice of capitalism around the world.

Variations in national capitalisms, in general, can be attributed to the fact that economies are path-dependent, that is, they have histories which shape the decisions which are made and

the institutions which arise, in any particular time period. These histories include the strength of various classes, the national experiences which countries have been through and the challenges which they face. "Markets" do not exist in institutional vacuums but, as sociologists such as Karl Polanyi (1944) have argued, are "embedded" in social structures. How markets operate depends, therefore, on how national capitalist economies have been forged and evolved.

Furthermore, many of the actors in capitalist economies – governments, firms and associations – function in ways which do not rely on "the market". Boyer and Hollingsworth (1997: 433), for example, two authors who stress the social and institutional framework within which economic activity takes place, argue that "some of the most competitive firms, regions, and nations are based on mechanisms of economic coordination that are totally different from pure market mechanisms". These methods of coordination range from internal hierarchies in case of the firms, to high levels of trust and cooperation (or social capital) for regions and nations, and to market-guiding government intervention at the national level. They all point to the need to consider the wider social, political and organizational structures within which capitalist profit-making takes place.

In the post-1945 period national capitalisms also varied because of the different specific challenges which they faced. The defeated countries of Japan and Germany faced a different set of challenges than the victorious powers. The Allied occupation of Japan in the immediate post-war period led to the adoption of a new constitution. Germany's fear of a repeat of the hyperinflation of the early 1930s was reflected in a strong role for a conservative Bundesbank. The history of colonialism in the

Third World led to nationalist movements in the post-1945 period, movements which sought independence and national control over their economies.

Of course, capitalist countries also faced many similar challenges. For example, it was clear in all of the advanced core capitalist countries that new institutional arrangements would be required to ensure that the demands of a stronger labour movement could be accommodated. Capitalism would need to be reformed to address labour's calls for greater economic security and a fairer distribution of income. In the core countries, the power of the organized working class and the extension of the franchise, while growing throughout the century, had by the end of the Second World War become sufficiently widespread that it was necessary for labour to be more fully incorporated into economic decision-making. Labour, at least in the core countries, had become a political force which could no longer be ignored or suppressed.

All capitalist countries were also left with the legacy of the devastation of the previous 50 years, a legacy which brought a determination and general acceptance of the need to find a more humane operational basis for capitalism. This was based not only on the experience of the 1930s but also on a necessity to meet the challenge posed by a rising Soviet Union offering a non-capitalist alternative. But the institutions which emerged in the face of these common challenges showed considerable variation between countries. A number of national capitalisms became evident as each country addressed the historical legacies and post-war challenges in different ways.

Most of the analyses of different varieties of national capitalism have focused on the core capitalist countries, especially on

the US, UK, Germany, Japan and the Scandinavian countries. I follow this convention here and first summarize the types of capitalism, drawing primarily on these countries. These varieties of capitalism are sometimes referred to as "models" of capitalism. This points to the fact that these national capitalisms can be seen as coherent sets of institutions which can be theorized at the abstract level. Following the overview of the versions or "models" of capitalism found in the core capitalist countries, I will also briefly discuss some of the other varieties of capitalism which have been found outside of the capitalist core.

How capitalisms differ: state–capital–labour relations

National capitalisms can be differentiated by the nature of the relations between the main agents in the economy, namely, the state, capital (itself sometimes divided between finance and industry) and labour. That is, national capitalisms can be differentiated by the ways in which state–capital–labour relations are organized. In some analyses, the distinctions between capitalisms are analysed in terms of variations in "state–market" relations, where the market referred to here consists of the actions of businesses and, with less frequency, the actions of labour.

Consider first, state–capital (or state–business) relations. These relations vary depending on the role assigned to the state in managing the economy. One model is for the state to be responsible for the macroeconomy but to play no direct or guiding role in the decisions taken by firms as to how much they should invest or in what fields to invest. A different approach is for the government to play a much larger direct or indirect role

in ensuring adequate levels of private investment and perhaps playing a role in the allocation of that investment to certain key industrial sectors, such as the microelectronics or heavy industry sectors, for example.

Secondly, how should capital–labour relations be managed? One model is for the state to provide the legal framework within which firms and trade unions must operate but, having provided this, to play little further role in determining the outcome of wage bargaining. In this approach, wage bargaining takes place in a decentralized fashion with the outcomes determined by the relative strengths of firms and unions in particular industries. A different approach is for the state, as well as providing a legal framework for the conduct of industrial relations, to take an active role in determining the level of wage settlements in the economy. This approach relies upon the government, employers and trade unions negotiating at the national level about what the economy can afford, how much will be distributed as wages and profits, and how much the government will provide in terms of welfare state provisions or the "social wage". Often referred to as "corporatism", this model relies on a more consensual form of capitalism.[1] It also points to a further way of distinguishing between national capitalisms – on the basis of the extent and forms of welfare states. A final "model" is for the state to actively impose forms of labour organization, and roles for trade unions, which seek to control the power of organized labour.

A further issue relating to capital–labour relations concerns how training is organized and who is responsible for it. If labour is, or is encouraged to be, mobile between firms, then any individual firm has little incentive to incur the cost of training workers. If it does so, it will pay the costs of training but the

worker may subsequently be poached by other firms who are able to offer higher wages precisely because they do not incur training costs themselves. In such a situation, firms are penalized if they provide training and the level of investment in workers in the economy is likely to be low. In this case, the state may step in to provide the training that firms would like but are unlikely to provide themselves. In other economies, workers may, through various incentives and mechanisms, be encouraged to stay with firms for a long period, perhaps even a lifetime of employment. In these circumstances, it is much more obviously in the firms' interests to provide worker training.

A third factor differentiating national capitalisms concerns the ways in which industry is financed. In this context, a distinction is typically made between stock market and bank based systems of industrial financing. In stock market based systems, firms raise their external funds through the issue of equities as well as through bank loans. Stock markets are therefore used as an intermediary between savers (individuals and institutional investors) and borrowers (the firms). The expected profitability of the firm is reflected in the stock market price and the manager of the firm is required to maximize profits in order to maximize the returns to shareholders. In this way, it is argued that stock markets discipline firm executives to act in the interests of the shareholders (rather their in their own interests); if they don't, share prices will fall and shareholders may replace the existing executives with more competent or profit-oriented executives. If executives are not utilizing the firm's resources efficiently, they also run the threat of being taken over by other firms who see an opportunity to reorganize production and increase profits. In theory, this is the role that stock markets play in capitalist economies.

Critics of the stock market based financial system argue that shareholders actually have very little oversight over firm executives; the latter frequently get huge salaries and bonuses despite the poor performance of their firms. Critics also argue that this system leads to "short-termism" where firm executives have to focus on short-term share prices and takeover threats to the detriment of long-run strategic planning and investment. The latter, it is argued, is best realized in a bank based financial system in which banks are the main lenders to firms. Banks, the argument runs, can use their expertise to better evaluate firm investment plans and, by developing long-term relationships with firms often including a seat on the firm's board, can provide long-term support for soundly managed firms. Opponents of this system argue that it can lead to bank–business relations becoming too close with the result that independent financial decisions are compromised, and that this model tends to disadvantage new firms entering the market.

Given these dimensions over which national capitalisms may vary, sumarized in Box 5.1, it is common to find a number of different types of capitalism identified among the major capitalist countries. Typically, between two and four varieties of capitalism are identified, with the membership of each variety depending on the precise features of capitalism under investigation.

Here, I distinguish between three broad types of capitalism. It should be remembered that these types are generalizations which seek to capture the basic features of particular countries, although important differences are still likely to remain even between countries which are members of the same type. The three types are the Anglo-American (or *laissez-faire* or liberal) model, the northern European (or corporatist) model, and the Japanese (or developmentalist) model.

BOX 5.1

How national capitalisms differ

1 In state–capital relations by the degree to which governments (or state agencies) directly intervene or guide investment decisions.

2 In state–capital–labour relations by the degree to which governments are involved in wage determination.

3 In state–labour relations by the extent and form of the welfare state (or the social wage).

4 In state–labour relations by the degree of state control over labour organizations and trade unions.

5 In state–capital–labour relations in terms of who provides training.

6 In industry–finance relations in terms of the relative importance of banks and stock markets in financing firms' investment.

The Anglo-American model: decentralized wage bargaining and stock markets

The Anglo-American model, based on the experience and institutional frameworks of capitalism in the US and the UK, has the following characteristics. It is a decentralized system in which wage bargaining is conducted without the direct intervention of the state. Capital–labour relations are conceived in basically adversarial terms and strikes are a normal part of industrial bargaining. The state provides, and often changes, the legal framework within which bargaining takes place. The changes in

the legal framework may be intended to strengthen the bargaining hand of one of the agents, capital or labour, at the expense of the other and, as a result, may be resisted from time to time by those disadvantaged. Labour markets are relatively "thick" in the sense that workers may move relatively freely between firms. Long-term contracts are relatively uncommon, with firms more likely to adjust to changes in demand by laying off workers, and firm investment in worker training is relatively low. This model is also characterized by a relatively high reliance on stock markets as financial intermediaries. The welfare state does not enter as part of an explicit bargain over a "social wage" but has a more residual form, especially in the US, where it has been designed to serve as a protection against poverty and as a safety net rather than as a more extensive vehicle aimed at promoting egalitarian outcomes. In the UK the welfare state played a more extensive role, especially in the 1945–1979 period; the US has been much closer to a low tax–low welfare state model. This Anglo-American model of capitalism gives a large coordinating role to markets and assigns a relatively small direct role to the state.

The northern European or corporatist model: consensual decision-making and a large welfare state

The northern European or corporatist model is typically attributed to countries such as Germany, Sweden and Norway and sometimes includes other countries such as Denmark and Belgium. These countries have developed a form of capitalism in which wage bargaining takes place at the national level typically between representatives of capital, labour and the state. The

national bargaining framework also covers welfare state services and income distribution objectives. This is a high tax–high welfare state model. Tripartite committees, between capital, labour and the state, form an important part of the overall policy framework. Workplace industrial relations have attempted to follow a more cooperative path, and industrial democracy, including having workers' representatives on company boards, has been given a higher profile in this model. Relations between employer and employee have been more stable, based on longer-term commitments and institutionalized through employment protection. Finance is primarily bank-based with long-term relationships established between banks and firms to whom they lend. Thus, this model is characterized by "patient capital" and "patient labour", to use German economist Wolfgang Streeck's (2001) terms. The compromise between capital and labour under this form of capitalism therefore differs substantially from the compromise reached in the case of Anglo-American capitalism. In the European corporatist model, capital and labour appear more as partners with the state in national economic planning. In the Anglo-American model, the state takes a back seat and independent capital and labour organizations confront each other in more adversarial terms.

An aside on varieties of welfare states

The classification of countries into different "varieties" changes depending on the issue being examined. I have classified countries according to state–capital–labour relations. In work focusing on the welfare state, however, Esping-Andersen (1990) proposes a division between liberal welfare states (as found in the US and

UK, for example), conservative/corporativistic welfare states (such as that found in Germany) and social democratic welfare states (as found in Norway and Sweden). In my analysis I have collapsed the latter two categories into one, since I am working at a more general level than a focus on the welfare state.

It is also worth noting that forms of the welfare state, since they influence the ways in which individuals and households relate to "the market", have implications for gender relations. Feminist analysis has differentiated between Esping-Andersen's "three worlds of welfare capitalism" on the basis of their implications for women. Ray Broomhill and Rhonda Sharp (2003) neatly summarize the implications in the following way. The liberal welfare state promotes a "dual breadwinner–female carer" gender contract in which women are expected to contribute to family income but to remain as primary care givers. In the conservative welfare state, policies have been structured to promote a "male breadwinner–female carer" gender contract in which more support is given to women to remain within the household. In the social democratic welfare state, a "dual breadwinner–state carer" gender contract has emerged in which policies are designed to permit a more equal sharing of work responsibilities but with substantial publicly funded caring. Varieties of welfare state, therefore, have important implications for gender relations.

Japanese (or East Asian) developmental capitalism: guiding the market and controlling labour

Corporatism finds resonance with the experience of the third variety of capitalism, national developmental capitalism, which

is associated with the Japanese model. Here too, bank based finance dominates, with the *keiretsu* model – one bank with a set of client enterprises – being the preferred model for organizing the financing of investment. Long-term relationships between banks and firms are mirrored by long-term relationships between firms – such as suppliers with their purchasers – and between firms with their employees. Indeed, until very recently, "lifetime employment" was the norm for large Japanese firms. Under these circumstances, labour mobility between firms was low and loyalty to the company was high. While these characteristics of the Japanese system demonstrate a commonality with the corporatist countries of northern Europe, other parts of the Japanese institutional framework depart from the northern European experience. This is particularly the case with respect to the role of labour. In Japan, trade unions were set up in 1945 under allied occupation, and a period of brutal and bloody strikes occurred during the next 15 years, culminating in the miners' strike of 1960. This was something of a watershed in Japanese industrial relations and after that a more consensual approach to industrial relations was implemented. In this system, unions were enterprise unions, that is, formed to represent the workers in one firm. This reduced the power of organized labour as a national force and led to a changed system of industrial relations in which company interests and worker interests were increasingly seen as overlapping.

The company formed a "mini-society" with workers increasingly identifying with "their" firm. A more egalitarian structure was encouraged with differences between shop floor workers and executives minimized (at least compared to the Anglo-American model). Pay scales reflected seniority as individuals

were rewarded for length of service with the firm. Union leaders frequently became members of the management. It should be noted, however, that this structure was only relevant for large companies in Japan. In the small business sector, these practices were not found and a much less "cooperative" framework existed here.

While the Japanese model has some important similarities with the northern European corporatist countries in terms of the more consensual approach taken to economic management and industrial relations, there were also some distinctive characteristics. These distinctive characteristics can also be found in other areas. For example, the welfare state is much smaller in Japan than in European countries. Welfare provision is more likely to be provided and organized at the family or company level than at the state level. Women's participation in the workforce is lower than in many other OECD countries and the gender wage-gap, that is, the difference between the average wages of men and women, is typically higher than those found elsewhere.

Japan is also distinctive in the extent to which government agencies influenced the investment decisions of private corporations. The Ministry of International Trade and Industry (MITI) has been singled out by many authors for its key role in guiding the investment of Japanese companies into microelectronics and computers in the 1960s and 1970s. State policies towards foreign direct investment, international trade, finance and technology acquisition were all critical in building up Japan's own industrial base, protecting it from foreign competitors and fostering its entry into global markets.

It is this state-led development strategy, characterized by state control or influence over finance, technology and trade,

which has led to the identification of a "Japanese model of capitalist development" followed by Japan in the decades following the end of the Second World War and then adopted by other East Asian economies such as Taiwan and South Korea from the mid-1960s. In line with the writings of Friedrich List and the earlier experience of Germany and the US, these "late, late industrializers" relied on a model of capitalism which involved a greater role for the state. This interpretation of the characteristics of capitalist development in key East Asian countries provides an alternative to that of Fukuyama (1992) outlined in Chapter 2. State–capital relations were such that in the case of South Korea, for example, economist Alice Amsden (1989) has argued that the giant South Korean firms (or *chaebols* such as Samsung and Hyundai) were disciplined by state agencies. These firms would receive financial support from the state-controlled banking system only if they met export (or other) targets set by the government. This Japanese or East Asian developmentalist model also relied on a form of state–labour relations which was inimical to the existence of independent trade unions for a significant part of the period of capitalist industrialization. The limited role of the welfare state, greater reliance on the family, and more unequal conditions of work for women were also common throughout the East Asian countries.

These three varieties of capitalism – Anglo-American, northern European and Japanese developmentalist – have received considerable attention. These varieties describe capitalism in some, but not all, of the core capitalist countries. France, for example, does not fit neatly into any of these three varieties, and would constitute a fourth variety of national capitalism based on high

levels of state planning but with less well-developed corporatist institutions than the northern European countries.

National varieties of capitalism as rivals

One question which is frequently asked is "Which variety of capitalism performs best?" "Best" is typically defined in terms of securing economic growth, full employment and distributional equity. This is a difficult question because describing institutional structures and measuring economic outcomes is easier to do than to establish causal relationships between them. Furthermore, the relative performance of the different types of capitalist model has also varied over time. In the 1960s, the 1970s and much of the 1980s, the growth of the Japanese, German and Scandinavian countries pointed to the superiority of these models. Faced with the turbulent decade of the 1970s when oil prices rose twice, it was argued that the corporatist countries were better able to adjust to these shocks because they had the institutional mechanisms in place which enabled societies to respond in relatively non-conflictual ways. In contrast, the UK was unable to effectively respond to the crises with its decentralized system of wage bargaining and its antagonistic industrial relations system. The US was argued to be in continual relative decline, with Japan, especially, increasingly challenging its economic predominance. Particularly in the 1980s and early 1990s, it was common to find books and articles on the Japanese "challenge", or more colourfully "threat", to the US and on predictions of economic "battles" and "wars" between the US and Japan. During this period, too, there was much talk of a coming "Pacific century" in which the centre of gravity of global

capitalism would shift from the Atlantic to the Pacific or from the US to Asia. In short, the varieties of national capitalism were interpreted not simply as being interesting institutional frameworks for analysis but as rival capitalisms.

For much of the post-war period it seemed, therefore, that the corporatist or Japanese models would predominate in this struggle between rival forms of capitalism. However, in the 1990s, the relative performance of the US and UK provided a counter to this prediction. In the 1990s, the US economy enjoyed its longest post-war boom and the UK shed its label of being the "sick man of Europe". In contrast, Japan entered a decade-long slump and European growth rates slowed as the centralized wage bargaining system and extensive welfare state provision were seen as detrimental to economic and social "flexibility". The changes in the performance of national capitalisms over time are explored further in the next chapter.

Varieties of capitalism: a matter of choice or history?

Can a country choose to adopt the institutional framework of a different type of capitalism or are there historical and cultural constraints which limit the degree of choice? Certainly, popular commentators such as Will Hutton (2002), in arguing for Britain to become more similar to the northern European model, and less like the US, believe that institutional frameworks are transferable and adaptation is possible. Indeed, there have been a number of examples in the post-1945 period of countries attempting to adopt the institutional features of other models. For example, "Japanese-style" industrial relations have been

introduced into "Anglo-American" settings, especially in the automobile industry. As another example, at the state level, Australia finds most resonance with the Anglo-American model but in the 1980s the Australian Labor Party introduced an "Accord" as a way of promoting more corporatist frameworks into the predominantly Anglo-American institutional setting. This experiment was problematic in that, lacking the deeper institutional foundations of corporatist countries, it often involved wage restraint on the part of labour but with little corresponding restraint on business (other than some form of "price restraint"). More often than not it collapsed into an unworkable "incomes policy" rather than being a genuine tool of social reform which changed the balance of power between capital, state and labour.[2] The same could be said of the "Social Contract" introduced by the British Labour Party in the 1970s.

The difficulties of transplanting the features of one variety of capitalism into another would not come as a surprise to those who point to the long historical roots of national capitalisms. They suggest a more cautious approach to the question of transferability. For example, the more interventionist, market constraining, variants of capitalism found in Germany and Japan have been argued to owe their origins to the industrialization process in these countries in the late nineteenth century. In the German case, Gerhard Lehmbruch (2001) argues that responses to the financial crises of the 1870s resulted in a sharing of state–private responsibilities which laid the basis for the subsequent development of corporatism. The importance of history is reinforced by Philip Manow (2001) who argues that the welfare state in Germany was developed in the late nineteenth century as a way of extending benefits to influential groups so as to

secure their commitment to the dominant system in the absence of political democracy. The welfare state was subsequently expanded on more universalist principles in the post-1945 period.

Manow (2001) further argues that the enterprise-based welfare system developed in Japan also dates from the late nineteenth century and resulted from the same pressures to provide benefits to key constituencies in the absence of political democracy. In the Anglo-American cases, welfare states were more a response to the rising power of labour and class struggle "from below" rather than from "top-down" conservative reformers trying to engineer social peace and cooperation as in the German and Japanese cases (see Streeck 2001: 13). These examples, by illustrating that state–capital–labour relations have evolved over decades (and even centuries) within specific national contexts, suggest that the scope for "model choice" may be constrained in important ways. The prospects for a "convergence" of national capitalisms under the forces of globalization are discussed further in Chapter 7.

Varieties of capitalism: Asia, Russia and Latin America

Capitalism varies between the core capitalist countries, between non-core countries, and between the core and non-core countries. The state-led developmental capitalism of some of the countries of East Asia can also be seen as a form of "authoritarian capitalism", given the suppression of independent labour movements which has characterized the growth process in these countries. This variety of capitalism is not, however, the only

way in which "Asian" capitalism has been described. Another popular interpretation places the emphasis on the role of "networks", particularly networks among the overseas Chinese diaspora. According to this interpretation, a unique brand of "Asian" or "Chinese" capitalism can be identified which relies heavily on personal relations and personal networks. "Markets", as arm's-length transactions between buyers and sellers who typically do not know each other, are less important in this model than personal contacts between participants who may be known to each other or connected through kinship or ethnic ties. These personal relations build levels of trust between agents in the economy which enable them to engage in transactions even where the security of private property or transparent regulation of the market is absent. Because of the role of kinship relations in these networks, and the role of the Chinese family-run business as the unit of production, this model is also sometimes referred to as being a "familial capitalism".

As a further variant, consider the capitalism that has emerged in Russia since the fall of communism. Here, the transition to capitalism occurred rapidly with the fall of Gorbachev in 1991. In came the IMF and Western economic advisors who proposed "shock therapy" to rapidly break the psychology of central planning and dependency on the state and to promote the "spontaneous" formation of markets. This, together with mass privatization, was to be the basis for capitalism. Bertram Silverman and Murray Yanowitch (2000: 128), in their study of the "New Russia", have argued that "unlike other capitalist countries, Russia started its transition to a modern market system as a state-controlled industrial economy and not as an economy characterized by early unbridled capitalism. Rather than humanizing

an already existing capitalist system by increasing the role of government, trade unions, and other voluntary associations, Russia needed to dismantle its state-controlled economy and replace it with a modern mixed economy." However, in the process of dismantling state control, the reforms destroyed institutional government structures and resulted in "the disintegration of the social order" (Silverman and Yanowitch 2000: 130). The state apparatus was weakened to the point where it could not operate as an effective check on business – indeed it became subservient to its aims and was easily corrupted as the lines between private and public spheres became increasingly blurred. The result was therefore a transition to what has been referred to earlier as "gangster capitalism" with businesses able to operate largely above the law. The result for the Russian people has been growing poverty so that anywhere from 30 to 50 per cent of the population are now reported to be living below the poverty line (with women disproportionately represented), huge inequalities between the new rich capitalist elite (often members of the previous communist bureaucracy) and ordinary people, growing social problems, and plummeting male life expectancy. The Russian people have also had to cope with a collapse in output worse than that experienced in Western Europe in the Great Depression of the 1930s. The Russian "model" of capitalism, therefore, has blurred the lines between state and capital and largely excluded labour altogether as a political force.

In Latin America, differentiating models of capitalism is more problematic than in the core capitalist countries. For one thing, as John Sheahan (2002: 25) notes, in Latin America "countries change their versions of capitalism more frequently, and more radically, than European countries do". Furthermore, the political

landscape is more complex, with military and/or authoritarian rule commonplace over the past half-century. As Sheahan argues (2002: 48), "Latin American capitalists have not been consistent enthusiasts for democracy. Nor have North American investors in the region."

Nevertheless, Sheahan suggests that two types of capitalism can be identified, although each has three sub-versions. The two broad versions are termed "liberal capitalism" (which corresponds most closely to the Anglo-American version discussed above) and a more "activist" version which stresses a greater economic role for the state in fostering development. Although there are some exceptions, the role of labour in Latin American capitalism is generally much weaker than in the core countries and is often repressed. One variant of the activist model allows for a more inclusionary political economy which typically provides greater opportunities for education than in other versions. The instability of regimes in the region has meant that many countries have, during the post-war period, experimented with several versions of capitalism, switching between liberal and activist versions and their sub-variants.

In Latin America, at least, governments have viewed alternative models of capitalism as policy choices. There remains some commonality between most of the experiments, however, in that patterns of landholding and income distribution are highly unequal and political power has remained concentrated in the hands of those closely allied to the holders of economic power, whether domestic or international.[3] As a result, poverty remains high, and by the end of the 1990s over half of the population of Latin America was living in poverty.[4]

State–capital relations in both Russia and, for most of the post-war period, much of Latin America can be characterized, therefore, as the state being the servant of the capital (and far removed from the imagined "impartial umpire" of the "ordered brawl"). It is not surprising to find many instances of corruption here as political leaders sought to enrich themselves in the process of ensuring that private firms were provided with a "favourable business environment". In other countries outside the core – the Philippines under Marcos and Zaïre (the Congo) under Mobutu come readily to mind – the state was powerful enough to enrich its leaders at the expense of the businesses that fed it, with the result that the "predatory" state drove the economy into an economic decline.

There is much talk today about the need for "good governance". Central elements in how countries are governed are the relationships between state, capital and labour. Many relationships are possible, with the result that some capitalisms are more humane and more productive than others. For example, some major gains for labour have been made in some states and in some periods, especially in the northern European corporatist countries during the period from 1945 to, say, 1990. Outside the core countries, capitalist countries are typically more repressive towards labour, more unequal in their outcomes and less democratic in their polities than their counterparts in the core. As capitalism has evolved in many parts of the world under the aegis of imperialism and colonialism, it has been less amenable to the types of progressive social policies which have been demanded and achieved in many Western capitalist societies. The ability of organized labour to play the same role in developing countries

that it has played in most of the core capitalist countries is constrained by its relatively small size (with a large part of the labour force in the agricultural and informal sectors) as well as by the frequency of state repression. The relations between state, capital and labour are rooted in history and while some changes in institutional structures are always possible, and frequently desirable, the scope for such changes is nevertheless constrained by historical factors. Changes in institutional structures do occur, however, as the capitalist revolution in the countries of the former Soviet bloc demonstrate.

The varieties of capitalism are not immune to historical change either. They have been presented here in a static way, designed to highlight their differences. Of course, none of the varieties of capitalism have gone unaltered in the last half of the twentieth century. They have all been faced with pressures for change from domestic and international sources. The next chapter analyses the changes in the nature of capitalism since 1945.

Further reading

For a comprehensive review of the main varieties of capitalism discussed in this chapter, together with an assessment of their relative performances, see David Coates, *Models of Capitalism: Growth and Stagnation in the Modern Era*, Malden, MA: Polity Press, 2000.

The differences between British and Japanese industrial relations systems is discussed in the classic, but now dated, work by Ronald Dore, *British Factory – Japanese Factory: The Origins of National Diversity in Industrial Relations*, Berkeley: University of

California Press, 1973. For an excellent account of capital–labour relations in post-war Japan, see John Price, *Japan Works: Power and Paradox in Postwar Industrial Relations*, Ithaca, NY: ILR/Cornell University Press, 1991. For the ways in which other countries in East Asia adopted developmentalist institutions and structures, see Gordon White, editor, *Developmental States in East Asia*, London: Macmillan, 1988. For the role of MITI in Japanese economic development, see Chalmers Johnson, *MITI and the Japanese Miracle: The Growth of Industrial Policy 1925–1975*, Stanford, CA: Stanford University Press, 1982.

For differences in welfare state systems, an influential book is Gosta Esping-Andersen's *The Three Worlds of Welfare Capitalism*, Princeton, NJ: Princeton University Press.

The damaging effects of IMF policies on Russia are documented by Joseph Stiglitz, a recent former chief economist at the World Bank, in *Globalization and its Discontents*, London: Norton, 2002. The inequalities arising under Russian capitalism are analysed in Bertram Silverman and Murray Yanowitch, *New Rich, New Poor, New Russia: Winners and Losers on the Russian Road to Capitalism*, second edition, Armonk, NY: Sharpe, 2000. For capitalist models and their applicability to Latin America, see Evelyn Huber, editor, *Models of Capitalism: Lessons for Latin America*, Pennsylvania: The Pennsylvania State Press, 2002.

Notes

1 "Corporatism" is a tricky concept and, like capitalism, can be found in a number of different guises. As well as the consensual form, outlined here, in which the state interacts with independent capital and labour organizations, it can also occur in authoritarian form where the state dominates the other two agents. This "authoritarian

corporatism" has characterized a number of countries in Latin America and East Asia.

2 See Stilwell (2000: Chapter 11) for the Australian case.

3 And, of course, these holders of power have limited the policy choices to alternative models of capitalism. Models based on socialism have often come to an abrupt end, such as in the case of Allende's Chile which resulted in the 1973 military coup. It remains to be seen if new directions arise from the Charez and Morales presidencies in Venezuela and Bolivia respectively.

4 Poverty is defined here as consumption less than one-third of the national average for 1993. See Sheahan (2002: 38).

CHAPTER 6

Post-1945 capitalism: variations over time

Introduction

CAPITALISM IS AN EVER-CHANGING system. The latter half of the twentieth century is no exception. Just as state–capital–labour relations differ between countries, so they vary over time for capitalist countries taken as a whole. Broadly speaking, the latter half of the twentieth century can be divided into three main periods. From 1945 to approximately 1970, the capitalist economies experienced a period of historically rapid growth based on the Bretton Woods agreement which set out the international architecture of the post-war capitalist order and on Keynesianism domestically. This period has been described as a "golden age" in which state, capital and labour combined to produce historically impressive economic results. The policies governing capitalist economies in this period were broadly consistent with those advocated by capitalism's reformist critics outlined in Chapter 3. The 1970s can be seen as a decade of