CHAPTER 3

How Have We Got Here?

A BRIEF HISTORY OF CAPITALISM

'*Mrs Lintott*: Now. How do you define history, Mr Rudge?
Rudge: Can I speak freely, Miss? Without being hit?
Mrs Lintott: I will protect you.
Rudge: How do I define history? It's just one fucking thing after another.'
ALAN BENNETT, *THE HISTORY BOYS*

One Fucking Thing after Another: What Use Is History?

Many readers probably feel the same way about history as young Rudge in *The History Boys* – Alan Bennett's hit play and 2006 film about a bunch of bright but underprivileged Sheffield boys trying to gain admission to Oxford to study history.

Many people consider **economic history**, or the history of how our economies have evolved, especially pointless. Do we really need to know what happened two, three centuries ago in order to know that free trade promotes economic growth, that high taxes discourage wealth creation or that cutting red tape encourages business activities? Aren't these and other economic wisdoms of our time all propositions derived from logically airtight theories and checked against a vast amount of contemporary statistical evidence?

The majority of economists agree. Economic history used to be a compulsory subject in graduate economics training in most American universities until the 1980s, but many of them don't even offer courses in economic history any more. Among the more theoretically oriented economists, there is even a tendency to consider economic history at best as a harmless distraction, like trainspotting, and at worst as a refuge for the intellectually challenged who cannot handle 'hard' stuff like mathematics and statistics.

However, I present my readers with a brief (well, not so brief) history of capitalism because having some knowledge of that history is vital to fully understanding contemporary economic phenomena.

Life is stranger than fiction: why history matters

History affects the present – not simply because it is what came before the present but also because it (or, rather, what people think they know about it) informs people's decisions. A lot of policy recommendations are backed up by historical examples because nothing is as effective as spectacular real-life cases – successful or otherwise – in persuading people. For example, those who promote free trade always point out that Britain and then the US became the world's economic superpowers through free trade. If they realized that their version of history is incorrect (as I will show below), they might not have such conviction in their policy recommendations. They would also find it harder to persuade others.

History also forces us to question some assumptions that are taken for granted. Once you know that lots of things that cannot be bought and sold today – human beings (slaves), child labour, government offices – used to be perfectly marketable, you will stop thinking that the boundary of the 'free market' is drawn by some timeless law of science and begin to see that it can be redrawn. When you learn that the advanced capitalist economies grew the fastest in history between the 1950s and the 1970s, when there were a lot

of regulations and high taxes, you will immediately become sceptical of the view that promoting growth requires cuts in taxes and red tape.

History is useful in highlighting the limits of economic theory. Life is often stranger than fiction, and history provides many successful economic experiences (at all levels – nations, companies, individuals) that cannot be tidily explained by any single economic theory. For example, if you only read things like *The Economist* or the *Wall Street Journal*, you would only hear about Singapore's free trade policy and its welcoming attitudes towards foreign investment. This may make you conclude that Singapore's economic success proves that free trade and the free market are the best for economic development – until you also learn that almost all the land in Singapore is owned by the government, 85 per cent of housing is supplied by the government-owned housing agency (the Housing Development Board) and 22 per cent of national output is produced by state-owned enterprises (the international average is around 10 per cent). There is no single type of economic theory – Neoclassical, Marxist, Keynesian, you name it – that can explain the success of this combination of free market and socialism. Examples like this should make you both more sceptical about the power of economic theory and more cautious in drawing policy conclusions from it.

Last but not least, we need to look at history because we have the moral duty to avoid 'live experiments' with people as much as possible. From the central planning in the former socialist bloc (and their 'Big Bang' transition back to capitalism), through to the disasters of 'austerity' policies in most European countries following the Great Depression, down to the failures of 'trickle-down economics' in the US and the UK during the 1980s and the 1990s, history is littered with radical policy experiments that have destroyed the lives of millions, or even tens of millions, of people. Studying history won't allow us to completely avoid mistakes in the present, but we should do our best to extract lessons from history before we formulate a policy that will affect lives.

If you have been persuaded by any of the above points, please read through the rest of the chapter, in which a lot of the historical 'facts' that you thought you knew may be challenged and thus the way you understand capitalism hopefully transformed at least a little bit.

Tortoise vs. Snails: the World Economy before Capitalism

Western Europe grew really slowly …

Capitalism started in Western Europe, especially in Britain and the Low Countries (what are Belgium and the Netherlands today) around the sixteenth and the seventeenth centuries. Why it started there – rather than, say, China or India, which had been comparable to Western Europe in their levels of economic development until then – is a subject of intense and long-running debate. Everything from the Chinese elite's disdain for practical pursuits (like commerce and industry), the discovery of the Americas and the pattern of Britain's coal deposits has been identified as the explanation. This debate need not detain us here. The fact is that capitalism developed first in Western Europe.

Before the rise of capitalism, the Western European societies, like all the other pre-capitalist societies, changed very slowly. The society was basically organized around farming, which used virtually the same technologies for centuries, with a limited degree of commerce and handicraft industries.

Between 1000 and 1500, the medieval era, **income per capita**, namely, income per person, in Western Europe grew at 0.12 per cent per year.[1] This means that income in 1500 was only 82 per cent higher than

that in 1000. To put it into perspective, this is a growth that China, growing at 11 per cent a year, experienced in just six years between 2002 and 2008. This means that, in terms of material progress, one year in China today is equivalent to eighty-three years in medieval Western Europe (which were equivalent to three-and-a-half medieval lifetimes, as the average life expectancy at the time was only twenty-four years).

… but its growth was still faster than elsewhere in the world

Having said all this, growth in Western Europe was still a sprint compared to those in Asia and Eastern Europe (including Russia), which are estimated to have grown at one-third the rate (0.04 per cent). This means that their incomes were only 22 per cent higher after half a millennium. Western Europe may have been moving like a tortoise, but other parts of the world were like snails.

The Dawn of Capitalism: 1500–1820

Capitalism is born – in slow motion

In the sixteenth century, capitalism was born. But its birth was so slow that we cannot easily detect it from the numbers. During 1500–1820, the growth rate of per capita income in Western Europe was still only 0.14 per cent – basically the same to all intents and purposes as the one for 1000–1500 (0.12 per cent).

In Britain and the Netherlands, there was visible growth acceleration by the late eighteenth century, especially in sectors such as cotton textiles and iron.[2] As a result, during 1500–1820, Britain and the Netherlands achieved per capita economic growth rates of 0.27 per cent and 0.28 per cent per year, respectively. These are very low by modern standards, but they were still double the Western European average. Behind this lay a number of changes.

Emergence of new sciences, technologies and institutions

First came the cultural shift towards more ‘rational’ approaches to understanding the world, which promoted the rise of modern mathematics and sciences. Many of these ideas were initially borrowed from the Arab world and Asia,[3] but in the sixteenth and seventeenth centuries, the Western Europeans started adding their own innovations. The founding fathers of modern science and mathematics – such as Copernicus, Galileo, Fermat, Newton and Leibniz – are from this era. This development of science did not immediately affect the broader economy, but it later enabled the systemization of knowledge that made technological innovations less dependent on individuals and thus more easily transferable, which encouraged the diffusion of new technologies and thus economic growth.

The eighteenth century saw the emergence of several new technologies that heralded the advent of a mechanized production system, especially in textiles, steel-making and chemicals.[*] As in Adam Smith’s pin factory, a finer division of labour was developing, with the use of continuous assembly lines spreading from the early nineteenth century. In the emergence of these new production technologies, a key driver was the desire to increase output in order to be able to sell more and thus make more profit – in other words, the spread of the capitalist mode of production. As Smith argued in his theory of division of labour, the increase in output made a finer division of labour possible, which then increased productivity and consequently output, setting off a ‘virtuous cycle’ between output growth and productivity growth.

New economic institutions emerged to accommodate the new realities of capitalist production. With the spread of market transactions, banks evolved to facilitate them. Emergence of investment projects requiring capital beyond the wealth of even the richest individuals prompted the invention of the *corporation*, or limited liability company, and thus the stock market.

Colonial expansion starts

The Western European countries started to expand rapidly outwards from the early fifteenth century. Euphemistically known as the ‘Age of Discovery’, this expansion involved expropriating land, resources and people for labour from the native populations through colonialism.

Beginning with Portugal in Asia and Spain in the Americas from the late fifteenth century, the Western European nations ruthlessly moved out. By the middle of the eighteenth century, North America was divided up between Britain, France and Spain. Most Latin American countries were ruled by Spain and Portugal until the 1810s and the 1820s. Parts of India were ruled by the British (mainly Bengal and Bihar), the French (the south-eastern coast) and the Portuguese (various coastal areas, especially Goa). Australia was beginning to be settled around this time (the first penal colony was established in 1788). Not much of Africa was affected yet, with small colonies along the coasts settled by the Portuguese (the formerly uninhabited islands of Cape Verde and Sao Tome and Principe) and the Dutch (Cape Town in the seventeenth century).

Colonialism was run on capitalist principles. Symbolically, until 1858, British rule in India was actually administered by a corporation (the East India Company), not by the government. These colonies brought new resources to Europe. The early expansions were motivated by the quest for precious metals to use as money (gold and silver) and spices (especially black pepper). Over time, plantations using slaves, mostly captives from Africa, were established in the new colonies – especially the US, Brazil and the Caribbean – to grow and bring back to Europe new crops such as (cane) sugar, rubber, cotton and tobacco. Some of the New World crops were grown in Europe and beyond and became basic food items. It stretches the imagination to think of the days when the British did not have their chips, the Italians lacked tomatoes and polenta (made with maize, or sweetcorn) and the Indians, the Thais and the Koreans did not eat any chillies.

Colonialism leaves big scars

There is a long-running debate on whether capitalism could have developed without the colonial resources of the sixteenth–eighteenth centuries – precious metal to be used as money, extra food sources such as potato and sugar and industrial inputs such as cotton.[4] While there is no question that the colonizers greatly benefited from those resources, those countries would probably have developed capitalism even without them. There is no question, however, that colonialism devastated colonized societies.

Native populations were exterminated or driven on to the margins. Their land, and the resources over and under it, were taken away. Marginalization of the indigenous population has been so extensive that Evo Morales, the current president of Bolivia, elected in 2006, is only the second head of state from the indigenous population in the Americas since the Europeans arrived in 1492 (the first was Benito Juarez, the Mexican president between 1858 and 1872).

Millions of Africans – 12 million is a common estimate – were captured and shipped out as slaves by both the Europeans and the Arabs. This was not only tragedy for those who became slaves (if they

survived the atrocious journey) but it also depleted many African societies of workers and destroyed their social fabric. Countries were created out of thin air, with arbitrary boundaries, affecting the internal and the international politics of those countries to this day. The fact that so many borders in Africa are straight is a testimony to that; natural borders are never straight because they are usually formed along rivers, mountain ranges and other geographical features.

Colonialism often meant the deliberate destruction of existing productive activities in the economically more advanced regions. Most importantly, in 1700, Britain banned the import of Indian cotton textiles ('calicoes') – we encountered the event in Chapter 2 – in order to promote its own cotton textile industry, dealing a heavy blow to the Indian cotton textile industry. The industry was finished off in the mid-nineteenth century by the influx of exports from the then mechanized British cotton textile industry. As a colony, India could not use tariffs and other policy measures to protect its own producers against British imports. In 1835, Lord Bentinck, the Governor-General of the East India Company, famously reported that 'the bones of the cotton weavers are bleaching the plains of India'.[5]

1820–1870: The Industrial Revolution

The turbo-charged drive: the Industrial Revolution starts

Capitalism really took off around 1820, with a visible acceleration of economic growth all around Western Europe and then in the 'Western offshoots' in North America and Oceania. The growth acceleration was so dramatic that the half-century following 1820 is typically referred to as the Industrial Revolution.[6]

In those fifty years, per capita income in Western Europe grew at 1 per cent, a poor growth rate these days (Japan grew at that rate during the so-called 'lost decade' of the 1990s), but compared to the 0.14 per cent growth rate between 1500 and 1820, it was a turbo-charged drive.

Expect to live for seventeen years and work eighty hours a week: misery increases for some

This acceleration of growth in per capita income, however, was initially accompanied by a fall in living standards for many. Some with old skills – such as textile artisans – lost their jobs, having been replaced by machines operated by cheaper, unskilled workers, including many children. Some machines were even designed with the small sizes of children in mind. Those who were hired to work in factories, or in the small workshops that supplied inputs for them, worked long hours – seventy to eighty hours per week was the norm, and some worked more than 100 hours a week with usually only half of Sunday free.

Working conditions were extremely hazardous. Many British cotton textile workers died of lung diseases from the dust generated in the production process. The urban working class lived in crowded conditions, sometimes fifteen to twenty people in a room. It was typical that hundreds of people shared one toilet. They died off like flies. In poor areas of Manchester, life expectancy was seventeen years[7] – 30 per cent *lower* than what it had been for the whole of Britain before the Norman Conquest, back in 1000 (then twenty- four years).

The rise of anti-capitalist movements

Given the misery that capitalism was creating, it is no wonder that various forms of anti-capitalist movements arose. Some of them merely tried to turn the clock back. The Luddites – textile artisans of England who lost their jobs to mechanized production in the 1810s – turned to destroying the machines,

the immediate cause of their unemployment and the most obvious symbol of capitalist progress. Others sought to build a better, more egalitarian society through voluntary associations. Robert Owen, the Welsh businessman, tried to build a society based on communal working and living among the like-minded – rather like the Israeli kibbutz.

The most important anti-capitalist visionary was, however, Karl Marx (1818–83), the German economist and revolutionary, who spent most of his time exiled in England – his grave is in Highgate Cemetery in London. Marx labelled Owen and others like him as 'utopian socialists' for believing that a post-capitalist society can be based on idyllic communal living. Calling his own approach 'scientific socialism', he argued that the new society should build on, rather than reject, the achievements of capitalism. A socialist society should abolish private ownership in the means of production but it should preserve the large production units created by capitalism so that it can take full advantage of their high productivities. Moreover, Marx proposed that a socialist society should be run like a capitalist firm in one important respect – it should plan its economic affairs centrally, in the same way in which a capitalist firm plans all its operations centrally. This is known as **central planning**.

Marx and many of his followers – including Vladimir Lenin, the leader of the Russian Revolution – believed that a socialist society could only be created through a revolution, led by workers, given that the capitalists would not voluntarily give up what they had. However, some of his followers, known as the 'revisionists' or social democrats, such as Eduard Bernstein and Karl Kautsky, thought that the problems of capitalism could be alleviated through the reform, rather than abolition, of capitalism through parliamentary democracy. They advocated measures like regulation of working hours and working conditions as well as the development of the welfare state.

With hindsight, it is easy to see that those reformists read the historical trend the best, as the system they advocated is what all the advanced capitalist economies have today. At the time, however, it was not obvious that workers could be made better off under capitalism, not least because there was fierce resistance to reform from most capitalists.

From around 1870, there were palpable improvements in the conditions of the working class. Wages went up. At least in Britain, the average adult wage was finally high enough to allow the workers to buy more than the bare necessities, and some workers were now working less than sixty hours a week. Life expectancy was up from thirty-six years in 1800 to forty-one years in 1860.[8] At the end of this period, there were even the beginnings of the welfare state, which started in Germany with the 1871 industrial accident insurance scheme, introduced by Otto von Bismarck, the Chancellor of the newly united Germany.

The myth of free market and free trade: How capitalism really developed

The advancement of capitalism in the Western European countries and their offshoots in the nineteenth century is often attributed to the spread of **free trade** and **free market**. It is only because the government in these countries, it is argued, did not tax or restrict international trade (free trade) and, more generally, did not interfere in the workings of the market (free market) that these countries could develop capitalism. Britain and the US are said to have forged ahead of other countries because they were the first ones to adopt the free market and, especially, free trade.

This could not be further from the truth. The government played a leading role in the early development of capitalism both in Britain and the US, as well as in other Western European countries.[9]

Britain as the pioneer of protectionism

Starting with Henry VII (1485–1509), the Tudor monarchs promoted the woollen textile industry – Europe's then hi-tech industry, led by the Low Countries, especially Flanders – through government intervention. **Tariffs** (taxes on imports) protected the British producers from the superior Low Country producers. The British government even sponsored the poaching of skilled textile artisans, mainly from Flanders, to gain access to advanced technologies. British or American people with names like Flanders, Fleming and Flemyng are descendants of those artisans: without those policies, there wouldn't be 007 (Ian Fleming) or penicillin (Alexander Fleming); and somehow I don't think *The Simpsons* would have been as fun as it is if Ned Flanders were called Ned Lancashire. These policies continued after the Tudors, and by the eighteenth century woollen textile goods accounted for around half of Britain's export revenue. Without those export revenues, Britain would not have been able to import the food and the raw materials that it needed for the Industrial Revolution.

British government intervention was stepped up in 1721, when Robert Walpole, Britain's first prime minister,[10] launched an ambitious and wide-ranging industrial development programme. It provided tariff protection and subsidies (especially to encourage export) to 'strategic' industries. Partly thanks to Walpole's programme, Britain started to forge ahead in the second half of the eighteenth century. By the 1770s, Britain was so obviously ahead of other countries that Adam Smith saw no need for protectionism and other forms of government intervention to help British producers. However, it was only nearly a century after Smith's *TWON* – in 1860 – that Britain fully switched to free trade, when its industrial supremacy was unquestioned. At the time, Britain accounted for 20 per cent of world manufacturing output (as of 1860) and 46 per cent of world trade in manufactured goods (as of 1870), despite having only 2.5 per cent of the world population; these numbers can be put into perspective by noting that the corresponding figures for China today are 15 per cent and 14 per cent, despite its having 19 per cent of the world population.

The US as the champion of protectionism

The US case is yet more interesting. Under British colonial rule, its development of manufacturing was deliberately suppressed. It is reported that, upon hearing about the first attempts by the American colonists to engage in manufacturing, William Pitt the Elder, the British prime minister (1766–8), said that they should 'not be permitted to manufacture so much as a horseshoe nail'.

After gaining independence, many Americans argued that their country should industrialize if it was to rub shoulders with the likes of Britain and France. Leading this camp was no less than the first ever minister in charge of the US economy, Alexander Hamilton, the treasury secretary (that's the one you see on the $10 bill). In his 1791 report to the Congress, *Report on the Subject of Manufactures*, Hamilton argued that the government of an economically backward nation, such as the US, needs to protect and nurture 'industries in their infancy' against superior foreign competitors until they grow up; this is known as the **infant industry argument**. Hamilton proposed the use of tariffs and other measures to help the infant industries; subsidies, public investments in infrastructure (especially canals), a patent law to encourage new inventions and measures to develop the banking system.

In the beginning, the slave-owning landlords from the South, who then dominated US politics, thwarted Hamilton's plan; they didn't see why they should buy inferior 'Yankee'-manufactured products when they could import better and cheaper things from Europe. But, following the Anglo-American War (1812–16) –

the first and so far the only time that the US mainland was invaded – many Americans came around to Hamilton's view that a strong country needed a strong manufacturing sector, which was not going to happen without tariffs and other government interventions. The only pity was that Hamilton was not around to see his vision realized. He had been shot dead in a pistol duel in 1804 by a certain Aaron Burr – the serving vice president of the country at the time (yes, those were wild days – a serving vice president shoots a former finance minister dead, and no one goes to prison).

After the shift of direction in 1816, the US trade policy became increasingly protectionist. By the 1830s, the country was boasting the highest average industrial tariff in the world – a status that it would keep for (almost all of) the next hundred years, until the Second World War. During that century, tariffs were much lower in states such as Germany, France and Japan – states that people these days normally associate with protectionism.

In the first half of this protectionist century, together with slavery and federalism, protectionism remained a constant bone of contention between the industrial North and the agrarian South. The issue was finally settled by the Civil War (1861–5), which the North won. The victory was no accident. The North won exactly because it had developed manufacturing industry in the previous half a century behind the wall of protectionism. In Margaret Mitchell's classic novel *Gone with the Wind*, Rhett Butler, the leading male character, tells his Southern compatriots that the Yankees would win the war because they had 'the factories, the foundries, the shipyards, the iron and coal mines – all the things we [the Southerners] haven't got'.

Free trade spreads – mostly through unfree means

Free trade was *not* responsible for the rise of capitalism, but it *did* spread throughout the nineteenth century. Some of it happened in the heartland of capitalism in the 1860s – Britain's adoption of free trade and the signing of a series of bilateral **free-trade agreements** (or FTAs), in which two countries abolish import restrictions and tariffs on each other's exports, among the Western European countries. But much of the spread happened on the periphery of capitalism, in Latin America and Asia.

This was the result of something that you would not normally associate with the word 'free' – that is, force, or at least the threat of using it. Colonization was the obvious route to 'unfree free trade', but even many countries that were not colonized were also forced to adopt free trade. Through 'gunboat diplomacy', they were forced to sign **unequal treaties** that deprived them of, among other things, **tariff autonomy** (the right to set their own tariffs).[11] They were allowed to use only a low uniform tariff rate (3–5 per cent) – enough to raise some government revenue but not enough for infant industry protection.

The most infamous unequal treaty is the Nanking Treaty, which China was forced to sign in 1842, following its defeat in the Opium War. But the unequal treaties had started with the Latin American countries, upon their independence in the 1810s and the 1820s. Between the 1820s and the 1850s, a string of other countries were forced to sign them – the Ottoman Empire (Turkey's predecessor), Persia (Iran today) and Siam (today's Thailand), and even Japan. The Latin American unequal treaties expired in the 1870s and the 1880s, but the Asian ones lasted well into the twentieth century.

The inability to protect and promote their infant industries, whether due to direct colonial rule or to unequal treaties, was a huge contributing factor to the economic retrogression in Asia and Latin America during this period, when they saw *negative* per capita income growths (at the rates of -0.1 and -0.04 per cent per year, respectively).

1870–1913: High Noon

Capitalism gets into a higher gear: the rise of mass production

The development of capitalism began to accelerate around 1870. Clusters of new technological innovations emerged between the 1860s and the 1910s, resulting in the rise of the so-called heavy and chemical industries: electrical machinery, internal combustion engines, synthetic dyes, artificial fertilizers, and so on. Unlike the technologies of the Industrial Revolution, which had been invented by practical men with good intuition, these new technologies were developed through the systematic application of scientific and engineering principles. This meant that, once something was invented, it could be replicated and improved upon very quickly.

In addition, organization of the production process was revolutionized in many industries by the invention of the **mass production system**. The use of a *moving* assembly line (conveyor belt) and interchangeable parts dramatically lowered production costs. This system of production is the backbone (if not the entirety) of our production system today, despite frequent talks of its demise since the 1980s.

New economic institutions emerge to deal with growing production scale, risk, and instability

During its ‘high noon’, capitalism acquired the basic institutional shape that it has today – the limited liability company, bankruptcy law, the central bank, the welfare state, labour laws and so on. These institutional shifts came about basically because of the changes in underlying technologies and politics.

Recognizing the growing need for large-scale investments, limited liability, hitherto reserved only for privileged firms, was ‘generalized’ – that is, granted to any firm that met some minimum conditions. Enabling unprecedented scales of investment, the limited liability company became the most powerful vehicle for capitalist development – Karl Marx, spotting its enormous potential before any self-appointed cheerleader of capitalism, called it ‘capitalist production in its highest development’.

Before the 1849 British reform, the bankruptcy law focused on punishing the bankrupt businessman, with a debtors’ prison in the worst case. New bankruptcy laws, introduced in the second half of the nineteenth century, gave failed businessmen a second chance by allowing them not to pay interest to creditors while they were reorganizing their business (as in Chapter 11 of the US Federal Bankruptcy Act, introduced in 1898) and by forcing the creditors to write off parts of their debts. Being a businessman became far less risky.

With larger companies came larger banks. The risk was then heightened that the failure of one bank could destabilisze the whole financial system, so central banks were set up to deal with such problems by acting as the lender of last resort, starting with the Bank of England in 1844.

With increasing socialist agitation and reformist pressures in relation to the condition of the working class, a raft of welfare and labour legislations were implemented from the 1870s: industrial accident insurance, health insurance, old age pensions and unemployment insurance. Many countries also banned the employment of younger children (typically, those under ten to twelve) and restricted the working hours of older children (initially only to twelve hours!). They also regulated the working conditions and hours of women. Unfortunately, this was done not out of chivalry but out of contempt for women. Unlike men, it was believed, women lacked full mental faculties and therefore could sign a labour contract that was disadvantageous to them – they needed to be protected from themselves. This welfare and labour legislation took the roughest edges off capitalism and made a lot of poor people’s lives better – if only slightly at the beginning.

These institutional changes promoted economic growth. Limited liability and debtor-friendly bankruptcy laws reduced risk involved in business activities, thereby encouraging wealth creation. Central banking, on the one hand, and labour and welfare legislations, on the other, also helped growth by enhancing, respectively, economic and political stability, which increased investment and thus growth. The growth rate of per capita income in Western Europe accelerated during this 'high noon' from 1 per cent during 1820–70 to 1.3 per cent during 1870–1913.

How the 'liberal' golden age was not so liberal

The 'high noon' of capitalism is often described as the first age of **globalization**, that is, the first time in which the whole world economy was integrated into one system of production and exchange. Many commentators attribute this outcome to the **liberal** economic policies adopted during this period, when there were few policy restrictions on cross-border movements of goods, capital and people. This liberalism on the international front was matched by the **laissez-faire** approach to domestic economic policy (see the box below for definitions of these terms). Allowance of maximum freedom for business, pursuit of a **balanced budget** (that is, the government spending exactly as much as it collects in taxes) and the adoption of the Gold Standard were the key ingredients, they say. Things were, however, far more complicated.

'LIBERAL': THE MOST CONFUSING TERM IN THE WORLD?

Few words have generated more confusion than the word 'liberal'. Although the term was not explicitly used until the nineteenth century, the ideas behind **liberalism** can be traced back to at least the seventeenth century, starting with thinkers like Thomas Hobbes and John Locke. The classical meaning of the term describes a position that gives priority to freedom of the individual. In economic terms, this means protecting the right of the individual to use his property as he pleases, especially to make money. In this view, the ideal government is the one that provides only the minimum conditions that are conducive to the exercise of such a right, such as law and order. Such a government (state) is known as the **minimal state**. The famous slogan among the liberals of the time was 'laissez faire' (let things be), so liberalism is also known as the laissez-faire doctrine.

Today, liberalism is usually equated with the advocacy of democracy, given its emphasis on individual political rights, including the freedom of speech. However, until the mid-twentieth century, most liberals were *not* democrats. They did reject the conservative view that tradition and social hierarchy should have priority over individual rights. But they also believed that not everyone was worthy of such rights. They thought women lacked full mental faculties and thus did not deserve the right to vote. They also insisted that poor people should not be given the right to vote, since they believed the poor would vote in politicians who would confiscate private properties. Adam Smith openly admitted that the government 'is in reality instituted for the defence of the rich against the poor, or of those who have some property against those who have none at all'.[12]

What makes it even more confusing is that, in the US, the term 'liberal' is used to describe a view that is the left-of-centre. American 'liberals', such as Ted Kennedy or Paul Krugman, would be called social democrats in Europe. In Europe, the term is reserved for people like the supporters of the German Free Democratic Party (FDP), who would be called **libertarians** in the US.

Then there is **neo-liberalism**, which has been the dominant economic view since the 1980s (see below). It is very close to, but not quite the same as, classical liberalism. Economically, it advocates the classical minimal state but with some modifications – most importantly, it accepts the central bank with note issue monopoly, while the classical liberals thought that there should be competition in the production of money too. In political terms, neo-liberals do not openly oppose democracy, as the classical liberals did. But many of them are willing to sacrifice democracy for the sake of private property and the free market.

Neo-liberalism is also known, especially in developing countries, as the **Washington Consensus** view, referring to the fact that it is strongly advocated by the three most powerful economic organizations in the world, all based in Washington, DC, namely, the US Treasury, the International Monetary Fund (IMF) and the World Bank.

The 1870–1913 period did *not* actually see universal liberalism on the international front. In the heartland of capitalism, in Western Europe and the US, trade protectionism actually increased, not decreased.

The US became even more protectionist than before following the conclusion of the Civil War in 1865. Most Western European countries that had signed FTAs in the 1860s and the 1870s did not renew them and significantly increased tariffs after their expiry (they usually had a twenty-year lifetime). This was partly to protect agriculture, which was struggling with new cheap imports from the New World (especially the US and Argentina) and Eastern Europe (Russia and Ukraine) but also to protect and promote the new heavy and chemical industries. Germany and Sweden were the best examples of this 'new protectionism' – famously called the 'marriage of iron and rye' in Germany.

When the unequal treaties they had signed upon independence expired in the 1870s and the 1880s, the Latin American countries introduced rather high protective tariffs (30–40 per cent). However, elsewhere in the 'periphery', the forced free trade we talked about earlier spread much further. European powers competed for parts of the African continent in the 'scramble for Africa', while many Asian countries were also taken as colonies (Malaysia, Singapore and Myanmar by Britain; Cambodia, Vietnam and Laos by France). The British Empire expanded enormously, backed up by its industrial might, leading to the famous saying: 'The sun never sets on the British Empire.' Countries like Germany, Belgium, the US and Japan, which had not so far engaged in much colonialism, also joined in.[13] Not for nothing is this period also known as the 'Age of Imperialism'.

The domestic front also saw a marked increase, not a decrease, in government intervention in the core capitalist countries. There was, indeed, a strong adherence to free-market doctrines in relation to fiscal policy (the balanced budget doctrine) and monetary policy (the Gold Standard). However, this period also saw an enormous increase in the role of the government: labour regulations, social welfare schemes, public investments in infrastructure (especially railways but also canals) and in education (especially the US and Germany).

The liberal golden age of 1870–1913 was thus not as liberal as we think. It was getting less liberal in the core capitalist countries, in terms of both domestic and international policies. Liberalization happened mostly in the weaker countries, but out of compulsion rather than choice – through colonialism and unequal treaties. In the only peripheral region that experienced rapid growth during this period, namely, Latin America, there was a vast increase in protectionism following the expiry of the unequal treaties.[14]

1914–45: The Turmoil

Capitalism trips up: the First World War and the end of the liberal golden age

The outbreak of the First World War in 1914 signalled the end of an era for capitalism. Until then, despite constant threats of revolt by the poor (the 1848 revolutions across Europe, the 1871 Paris commune, etc.) and economic problems (the Long Depression of 1873–96), the only way for capitalism had seemed to be up – and outwards.

This view was rudely shaken by the First World War (1914–18), which totally discredited the then popular view that the thickening web of commerce, which capitalism was building across the globe, would make wars between nations thus intertwined highly unlikely, if not totally impossible.

At one level, the outbreak of the First World War should not have been surprising, given that the globalization of the 'high noon' had been in large part driven by imperialism, rather than market forces. This meant that the international rivalry between the leading capitalist countries had a high chance of escalating into violent conflicts. Some went even further and argued that capitalism had reached a stage in which it could not be sustained without continuous outward expansion, which has to come to an end sooner or later, marking the end of capitalism.

Capitalism gets a rival: the Russian Revolution and the rise of socialism

This was the view most famously expounded in *Imperialism: The Highest Stage of Capitalism* by Vladimir Lenin, the leader of the Russian Revolution in 1917. The Russian Revolution was an even bigger shock to the defenders of capitalism than the First World War, as it led to the creation of an economic system that claims to undermine all the cornerstones of capitalism.

In the decade following the Russian Revolution, private property in the means of production (machines, factory building, land, etc.) was abolished. The big break came with the agricultural collectivization in 1928, in which the lands of large farmers, or kulaks, were confiscated and turned into state farms (*sovkhoz*) and small farmers were forced to join agricultural cooperatives (*kolkhoz*), which were state farms in all but name. Markets were eventually abolished and replaced by full-blown central planning by 1928, when the first Five Year Plan started. By 1928, the Soviet Union had an economic system that was definitively not capitalist. It ran without private ownership of means of production, profit motives and markets.

As for the other cornerstone of capitalism, wage labour, the picture was more complicated. Yes, in theory the Soviet workers were not wage labourers because they owned all the means of production – through state ownership or cooperatives. In practice they were indistinguishable from wage labourers in a capitalist economy, since they had little control over the way in which their enterprises and the wider economy operated, and their daily work experience was still subject to the same hierarchical relationship.

Soviet socialism was a huge economic (and social) experiment. Until then, no economy had been centrally planned. Karl Marx had left the details rather vague, and the Soviet Union had to make things up as it went along this untrodden path. Even many Marxists, especially Karl Kautsky, were sceptical about its prospects – socialism was, according to Marx himself, supposed to emerge from the most developed capitalist economies. Those economies were only a step away from a fully planned economy, it was argued, because their economic activities were already planned to a high degree by large enterprises and cartels of those enterprises. The Soviet Union – even its more developed European part – was a very backward economy in which capitalism had been hardly developed, where socialism really had no business emerging.

To everyone's surprise, the early Soviet industrialization was a big success, most graphically proven by its ability to repel the Nazi advance on the Eastern Front during the Second World War. Income per capita is estimated to have grown at 5 per cent per year between 1928 and 1938 – an astonishingly rapid rate in a world in which income typically grew at 1–2 per cent per year.[15]

This growth came at the cost of millions of deaths – from political repression and the 1932 famine.[*] However, the scale of the famine was not known at the time, and many were impressed by Soviet economic performance, especially given that capitalism was then on its knees, following the Great Depression of 1929.

Capitalism gets depressed: the Great Depression of 1929

The Great Depression was an even more traumatic event for the believers in capitalism than the rise of socialism. This was especially the case in the US, where the Depression started (with the infamous 1929 Wall Street crash) and which was the hardest hit by the experience. Between 1929 and 1932, US output fell by 30 per cent and unemployment increased eightfold, from 3 per cent to 24 per cent.[16] It was not until 1937 that US output regained its 1929 level. Germany and France also suffered badly, with their outputs falling by 16 per cent and 15 per cent respectively.

One influential view, propagated by neo-liberal economists, is that this large but totally manageable financial crisis was turned into a Great Depression because of the collapse in world trade caused by the 'trade war', prompted by the adoption of protectionism by the US through the 1930 Smoot-Hawley Tariffs. This story does not stand up to scrutiny. The tariff increase by Smoot-Hawley was not dramatic – it raised the average US industrial tariff from 37 per cent to 48 per cent. Nor did it cause a massive tariff war. Except for a few economically weak countries such as Italy and Spain, trade protectionism did not increase very much following Smoot–Hawley. Most importantly, studies show that the main reason for the collapse in international trade after 1929 was not tariff increases but the downward spiral in international demand, caused by the adherence by the governments of the core capitalist economies to the doctrine of balanced budget.[17]

After a big financial crisis like the 1929 Wall Street crash or the 2008 global financial crisis, private-sector spending falls. Debts go unpaid, which forces banks to reduce their lending. Being unable to borrow, firms and individuals cut their spending. This, in turn, reduces demands for other firms and individuals that used to sell to them (e.g., firms selling to consumers, firms selling machinery to other firms, workers selling labour services to firms). The demand level in the economy spirals down.

In this environment, the government is the only economic actor that can maintain the level of demand in the economy by spending more than it earns, that is, by running a budget deficit. However, in the days of the Great Depression, the strong belief in the doctrine of the balanced budget prevented such a course of action. As tax revenues were falling due to reduced levels of economic activity, the only way for them to balance their budgets was to cut their spending, leaving nothing to arrest the downward demand spiral.[18] To make things worse, the Gold Standard meant that their central banks could not increase the supply of money for fear of compromising the value of their currencies. With restricted money supply, credit became scarce, restricting private-sector activities and thus reducing demand even further.

Reform begins: the US and Sweden lead the way

The Great Depression left a lasting mark on capitalism. With it came widespread rejection of the laissez-faire doctrine and serious attempts to reform capitalism.

The reforms were particularly widespread and far-reaching in the US, where the Depression was the greatest and lasted the longest. The so-called First New Deal programme (1933–4) under the new president, Franklin Delano Roosevelt, separated the commercial and investment arms of banks (the 1933 Glass-Steagall Act), set up the bank deposit insurance system to protect small savers against bank failures, tightened stock market regulation (the 1933 Federal Securities Act), expanded and strengthened the farm credit system, provided a minimum farm price guarantee and developed infrastructure (such as the Hoover Dam – that's the one you see in the 1978 *Superman* movie, starring the late Christopher Reeve), and so on. There were even more reforms under the so-called Second New Deal (1935–8),

including the Social Security Act (1935), which introduced old age pensions and unemployment insurance, and the Wagner Act (1935), which strengthened trade unions.

Sweden was another country where significant reforms were introduced. Riding on the back of the public discontent with liberal economic policies, which left unemployment at 25 per cent, the Social Democratic Party came to power in 1932. Income tax was introduced – surprisingly belatedly for a country that is today considered the bastion of income tax (Britain introduced income tax in 1842 and even the famously anti-tax US in 1913). The revenues were used for expanding the welfare state (unemployment insurance was introduced in 1934, and the old-age pension was raised) and for helping small farmers (farm credits were expanded, and minimum prices were guaranteed). In 1938, the centralized trade union and the centralized employers' association signed the Saltsjöbaden Agreement, establishing industrial peace.

Other countries did not go as far as the US and Sweden in reforming capitalism, but their reforms presaged the shape of the things to come after the Second World War.

Capitalism falters: growth slows down and socialism outperforms capitalism

The turmoil of the 1914–45 period reached its peak with the outbreak of the Second World War, which killed tens of millions of people, both soldiers and civilians (higher estimates put the death toll at 60 million). The war resulted in the first reversal in the acceleration in economic growth since the early nineteenth century.[19]

1945–73: The Golden Age of Capitalism

Capitalism performs well on all fronts: growth, employment and stability

The period between 1945, the end of the Second World War, and 1973, the first Oil Shock, is often called the 'Golden Age of capitalism'. The period really deserves the name, as it achieved the highest growth rate ever. Between 1950 and 1973, per capita income in Western Europe grew at an astonishing rate of 4.1 per cent per year. The US grew more slowly, but at an unprecedented rate of 2.5 per cent. West Germany grew at 5.0 per cent, earning the title of the 'Miracle on the Rhine', while Japan grew even faster at 8.1 per cent, starting off the chain of 'economic miracles' in East Asia in the next half a century.

High growth was not the only economic achievement of the Golden Age. Unemployment, the bane of the working class, was virtually eliminated in the advanced capitalist countries (henceforth ACCs) of Western Europe, Japan and the US (see Chapter 10). These economies were also remarkably stable on a number of accounts – output (and thus employment), prices and finance. Outputs fluctuated much less than in the previous periods, not least thanks to Keynesian fiscal policy, which increased government spending during downturns and reduced it during booms.[20] The rate of *inflation*, that is, the rate at which the general price level rises, was relatively low.[21] And there was a very high degree of financial stability. During the Golden Age, virtually no country was in banking crisis. In contrast, since 1975, anything between 5 and 35 per cent of countries in any given year have been in banking crisis, except for a few years in the mid-2000s.[22]

So in every measure the Golden Age was a remarkable period. When Harold Macmillan, the British prime minister, said, 'You've never had it so good,' he wasn't exaggerating. Exactly what lay behind this

sterling economic performance, which was unprecedented and has since been unparalleled, is a matter of an ongoing dispute.

Factors behind the Golden Age

Some point out that, after the Second World War, there was an unusually large pool of new technologies that were waiting to be exploited, which gave an impetus to growth in the Golden Age. Many new technologies that had been developed during the war for military purposes had civilian uses – computers, electronics, radar, jet engines, synthetic rubber, microwave (applied from radar technology) and much more. With the end of the war, a lot of new investments that use these technologies were made, first for post-war reconstruction and then for the meeting of consumer demands pent up during wartime austerity.

There were also some important changes in the international economic system that facilitated economic development during the Golden Age.

The 1944 meeting of the Allies in the Second World War in the New Hampshire resort of Bretton Woods established two key institutions of the post-war international financial system, which are thus dubbed the Bretton Woods Institutions (BWIs) – the International Monetary Fund (IMF) and the International Bank for Reconstruction and Development (IBRD), more commonly known as the World Bank.[23]

The IMF was established to provide short-term funding to countries in **balance of payments** crises (balance of payments is the statement of a country's position in economic transactions with the rest of the world – see Chapter 12 for full details). A balance of payments crisis happens when a country is paying other countries (e.g., when it imports goods or services) so much more than it gets from them that no one is willing to lend money to it any more. The typical result is a financial panic, followed by a deep recession. By providing emergency loans to countries in such a situation, the IMF allowed them to tide over such crises with fewer negative consequences.

The World Bank was established to provide loans for 'project lending' (that is, money that is given to particular investment projects, such as building a dam). By providing loans of longer maturities and/or lower interest rates than are offered by the private-sector banks, the World Bank enabled its client countries to invest more aggressively than otherwise possible.

Making up the third leg of the post-war world economic system was the GATT (General Agreement on Trade and Tariffs), which was signed in 1947. Between 1947 and 1967, the GATT organized six series of negotiations (called 'rounds') that resulted in cuts in tariffs (mostly) among the rich countries. Being between countries at similar levels of development, these cuts brought about positive outcomes by expanding markets and stimulating productivity growth through greater competition.

In Europe, a new experiment in international integration with far-reaching consequences was conducted. It started with the creation of the European Coal and Steel Community (ECSC) in 1951 by six countries (West Germany, France, Italy, the Netherlands, Belgium and Luxembourg) and culminated in the creation of the European Economic Community (EEC) – a free-trade agreement – through the Treaty of Rome (1957).[24] In 1973, the UK, Ireland and Denmark joined the group, which was by then called the EC (European Communities). By bringing peace to a region riven with wars and rivalries and by integrating markets, the EEC contributed to the economic development in the member countries.

The most influential explanation of the Golden Age is, however, that it was mainly the result of reforms in economic policies and institutions that gave birth to the **mixed economy** – mixing positive features of

capitalism and socialism.

Following the Great Depression, the limits of laissez-faire capitalism came to be widely accepted. It was agreed that the government should take an active role to deal with the failings of unregulated markets. At the same time, the success in wartime planning during the Second World War diminished scepticism about the feasibility of government intervention. Electoral successes by parties of the left in many European countries, thanks to their key roles in fighting fascism, led to the expansion of the welfare state and greater labour rights.

These changes in policies and institutions are seen to have contributed to the making of the Golden Age in a number of ways – creating social peace, encouraging investment, increasing social mobility and promoting technological innovations. Let me elaborate a little, as this is an important point.

Capitalism Remixed: pro-worker policies and institutions

Soon after the Second World War, many European countries took private enterprises into public ownership or set up new **public enterprises**, or **state-owned enterprises** (SOEs), in key industries, such as steel, railways, banking and energy (coal, nuclear and electricity). These were reflective of the European socialist movements' belief in public control over the means of production as a key element of social democracy, as embodied in the famous Clause IV of the British Labour Party (abolished in 1995 under Tony Blair's 'New Labour' make-over). In countries such as France, Finland, Norway and Austria, SOEs are deemed to have played a key role in generating high growth during the Golden Age by aggressively moving into high-technology industries that the private sector firms found too risky.

Welfare measures, first introduced in the late nineteenth century, were vastly strengthened, with the provision of some basic services nationalized in some countries (e.g., Britain's National Health Service). These were funded by a large increase in taxes (as a proportion of national income). Better welfare measures increased social mobility, increasing the legitimacy of the capitalist system. The resulting social peace encouraged more long-term-oriented investments and thus growth.

Managed capitalism: governments regulate and shape markets – in a variety of ways

Learning the lessons of the Great Depression, governments in all ACCs started to deploy deliberately **counter-cyclical macroeconomic policies**, also known as Keynesian policies (see Chapter 4), expanding government spending and money supply from the central bank during economic downturns and reducing them during upturns.

In recognition of the potential dangers of unregulated financial markets, as manifested in the Great Depression, financial regulations were strengthened. Few countries went as far as the US in separating investment banking from commercial banking, but they all had restrictions on what banks and financial investors can do. This was an era when bankers were considered to be respectable but boring people, unlike their swashbuckling successors today.*

Many governments practised **selective industrial policy** that deliberately promoted targeted 'strategic' industries through a range of measures, such as trade protection and subsidies. The US government officially had no industrial policy but greatly influenced the country's industrial development by providing massive research funding to advanced industries such as computers (funded by the Pentagon), semi-conductors (US Navy), aircraft (US Air Forces), the internet (the DARPA, Defense Advanced Research Projects Agency), and pharmaceuticals and life sciences (National Institutes of Health).[25] Governments in countries such as France, Japan and South Korea did not stop at promoting particular

industries and explicitly coordinated policies across industrial sectors through their Five Year Plans – an exercise known as **indicative planning**, to distinguish it from the 'directive' Soviet central planning.

The new dawn: developing countries finally have a go at economic development

The Golden Age saw widespread decolonization. Starting with Korea in 1945 (which was then divided into North and South in 1948) and India (from which Pakistan separated) in 1947, most colonies gained independence. Independence in many nations involved violent struggles against the colonizers. Independence came later to Sub-Saharan Africa, with Ghana becoming the first independent country in 1957. Around half the Sub-Saharan African countries became independent in the first half of the 1960s. Some nations had to wait much longer (Angola and Mozambique in 1975 from Portugal; Namibia in 1990 from South Africa), and some are still waiting, but the vast majority of former colonial societies – now called developing countries – gained independence by the end of the Golden Age.

Upon independence, most post-colonial nations rejected the free-market and free-trade policies that had been imposed on them under colonialism. Some of them became outright socialist (China, North Korea, North Vietnam and Cuba), but most of them pursued state-led industrialization strategies while basically remaining capitalist. The strategy is known as the **import substitution industrialization** (ISI) strategy – so called because you are substituting imported manufactured goods with your own. This was done by protecting domestic producers from superior foreign competition by restricting imports (infant industry protection) or heavily regulating the activities of foreign companies operating within national borders. Governments often subsidized private-sector producers and set up SOEs in industries in which private-sector investors were unwilling to invest due to high risk.

With independence dates stretching from 1945 to 1973 and beyond, it is impossible to talk about the 'economic performance of developing countries during the Golden Age'. The usual compromise timeframe for judging developing country economic performance is 1960–80. According to the World Bank data, during this period, per capita income in the developing countries grew at 3 per cent per year, which meant that they kept pace with the more advanced economies, in which growth was 3.2 per cent. The 'miracle' economies of South Korea, Taiwan, Singapore and Hong Kong grew at 7–8 per cent per year in per capita terms during this period, achieving some of the fastest growth rates in human history (together with Japan before them and China after them).

One thing to note, however, is that even the more slowly growing developing regions saw considerable progress during this period. During 1960–80, with per capita income growth of 1.6 per cent per year, Sub-Saharan Africa was the slowest-growing region in the world – Latin America grew at double that rate (3.1 per cent), and East Asia at more than triple that rate (5.3 per cent). However, this is still not a growth rate to be sniffed at. Recall that during the Industrial Revolution, the growth rate of per capita income in Western Europe was only 1 per cent.

The middle way: capitalism works the best with appropriate government interventions

During the Golden Age of capitalism, government intervention increased enormously in almost all areas in all countries, with the exception of international trade in the rich countries. Despite this, economic performance both in the rich and in the developing countries was much better than before. It has not been bettered since the 1980s, when state intervention was considerably reduced, as I shall show shortly. The Golden Age shows that capitalism's potential can be maximized when it is properly regulated and stimulated by appropriate government actions.

1973–9: The Interregnum

The Golden Age started to unravel with the suspension of US dollar–gold convertibility in 1971. In the Bretton Woods system, the old Gold Standard was abandoned on the recognition that it made macroeconomic management too rigid, as seen during the Great Depression. But the system was still ultimately anchored in gold, because the US dollar, which had fixed exchange rates with all the other major currencies, was freely convertible to gold (at $35 per ounce). This, of course, was based on the assumption that the dollar was 'as good as gold' – not an unreasonable assumption when the US was producing about half of the world's output and there was an acute dollar shortage all around the world, as everyone wanted to buy American things.

With the post-war reconstruction and then rapid development of other economies, this assumption was not valid any more. Once people realized that the US dollar was not as good as gold, they had a greater incentive to convert dollars into gold, which reduced the US gold reserve even further and made the dollar look even less reliable. The US official liabilities (dollar bills and Treasury Bills, namely, the US government bonds), which had been only half the size of its gold reserve until 1959, became one and a half times larger by 1967.[26]

In 1971, the US dropped its commitment to convert any dollar claims into gold, which led other countries to abandon the practice of tying their national currencies to the dollar at fixed rates over the next couple of years. This created instability in the world economy, with currency values fluctuating according to market sentiments and becoming increasingly subject to currency speculation (investors betting on currencies moving up or down in value).

The end of the Golden Age was marked by the First Oil Shock in 1973, in which oil prices rose fourfold overnight, thanks to the price collusion of the cartel of the oil-producing countries, OPEC (Organization of Petroleum Exporting Countries). Inflation had been slowly increasing in many countries since the late 1960s but, following the Oil Shock, it shot up.

More importantly, the next several years were characterized by **stagflation**. This newly coined term referred to the breakdown of the age-long economic regularity that prices fall during a recession (or stagnation) and rise during a boom. Now, the economy was stagnating (albeit not exactly in a prolonged recession, like during the Great Depression) but prices were rising fast, at 10, 15 or even 25 per cent per year.[27]

The Second Oil Shock in 1979 finished off the Golden Age by bringing about another bout of high inflation and helping neo-liberal governments come to power in the key capitalist countries, especially in Britain and the US.

This period is often depicted as one of an unmitigated economic disaster by free-market economists, who are critical of the mixed economy model. This is misleading. Growth in the ACCs may have slowed down compared to the Golden Age, but, at 2 per cent per capita, income growth rate during 1973–80 was still much higher than any period up to the Second World War (1.2–1.4 per cent) and slightly higher than what followed in the next three decades of neo-liberalism (1.8 per cent for 1980–2010).[28] The unemployment rate, at 4.1 per cent average, was higher than that of the Golden Age (3 per cent), but not by much.[29] Still, the fact remains that there was enough dissatisfaction with economic performance during this period for there to be radical changes in the following years.

1980–Today: The Rise and Fall of Neo-liberalism

The Iron Lady: Margaret Thatcher and the end of British post-war compromise

A major turning point came with the election of Margaret Thatcher as the British prime minister in 1979. Rejecting the post-Second World War 'wet' Tory compromise with Labour, Thatcher began a radical dismantling of the mixed economy, in the process earning the sobriquet 'The Iron Lady' for her uncompromising attitude.

The Thatcher government lowered higher-rate income taxes, reduced government spending (especially in education, housing and transport), introduced laws reducing union power and abolished **capital control** (restriction on the cross-border movement of money). The most symbolic move was **privatization** – sales of SOEs to private investors. Gas, water, electricity, steel, airline, automobile and parts of public housing were privatized.

Interest rates were raised in order to reduce inflation by dampening economic activities and thus demand. The high interest rate attracted foreign capital, driving up the value of the British pound, thus making British exports uncompetitive. The result was a huge recession, as consumers and companies retrenched, between 1979 and 1983. Unemployment soared to 3.3 million people – this under a government that came to power by criticizing James Callaghan's Labour government's record on unemployment, which went over the 1 million mark, with the famous slogan 'Labour isn't working', invented by the advertising agency Saatchi & Saatchi.

During the recession, a huge chunk of British manufacturing industry, which had already been suffering from declining competitiveness, was destroyed. Many traditional industrial centres (such as Manchester, Liverpool and Sheffield) and mining areas (North England and Wales) were devastated, as depicted in movies such as *Brassed Off* (about coal miners in Grimley, a thinly disguised version of Yorkshire coal town Grimethorpe).

The actor: Ronald Reagan and the re-making of the US economy

Ronald Reagan, the former actor and a former governor of California, became the US president in 1981 and outdid Margaret Thatcher. The Reagan government aggressively cut the higher income tax rates, explaining that these cuts would give the rich greater incentives to invest and create wealth, as they could keep more of the fruits of their investments. Once they created more wealth, it was argued, the rich would spend more, creating more jobs and incomes for everyone else; this is known as the **trickle-down theory**. At the same time, subsidies to the poor (especially in housing) were cut and the minimum wage frozen so that they had a greater incentive to work harder. When you think about it, this was a curious logic – why do we need to make the rich richer to make them work harder but make the poor poorer for the same purpose? Curious or not, this logic, known as **supply-side economics**, became the foundational belief of economic policy for the next three decades in the US – and beyond.

As in the UK, interest rates were jacked up in an attempt to reduce inflation. Between 1979 and 1981, interest rates more than doubled from around 10 per cent to over 20 per cent per year. A significant portion of the US manufacturing industry, which had already been losing ground to Japanese and other foreign competition, could not withstand such an increase in financial costs. The traditional industrial heartland in the Midwest was turned into 'the Rust Belt'.

Financial deregulation in the US at this time laid the foundation for the financial system we have today. The rapid increase in **hostile takeovers**, in which a company is taken over against the will of the existing

management, changed the whole corporate culture in the US. Many of those taking over were 'corporate raiders' only interested in **asset stripping** (namely, the sales of valuable assets, regardless of the impact on the long-term viability of the company), immortalized by Gordon 'Greed-is-good' Gekko in the 1987 movie *Wall Street*. To avoid such a fate, firms had to deliver profits faster than before. Otherwise impatient shareholders would sell up, reducing the share prices and thus exposing the firm to greater danger of hostile takeover. The easiest way for companies to deliver quick profit was through **downsizing** – reducing the workforce and minimizing investments beyond what is necessary for immediate results, even though these actions diminish the prospect of the company in the longer run.

The Third World debt crisis and the end of the Third World Industrial Revolution

The most lasting legacy of the high interest rate policy in the US in the late 1970s and the early 1980s – sometimes called the Volcker Shock, named after the then chairman of the US central bank (the Federal Reserve Board) – was *not* in the US but in the developing countries.

Most developing countries had borrowed heavily in the 1970s and the early 1980s, partly to finance their industrialization and partly to pay for the more expensive oil, following the Oil Shocks. When the US interest rates doubled, so did international interest rates, and this led to a widespread default on foreign debts by developing nations, starting with the default of Mexico in 1982. This is known as the **Third World Debt Crisis**, thus known because the developing world was then called the Third World, after the First World (the advanced capitalist world) and the Second World (the socialist world).

Facing economic crises, developing countries had to resort to the Bretton Woods Institutions (the IMF and the World Bank, just to remind you). The BWIs made it a condition that borrowing countries implement the **structural adjustment programme** (SAP), which required shrinking the role of the government in the economy by cutting its budget, privatizing SOEs and reducing regulations, especially on international trade.

The results of the SAP were extremely disappointing, to say the least. Despite making all the necessary 'structural' reforms, most countries experienced dramatic growth slowdown in the 1980s and the 1990s. Per capita income growth rates in Latin America (including the Caribbean) collapsed from 3.1 per cent in 1960–80 to 0.3 per cent in 1980–2000. In Sub-Saharan Africa (SSA), per capita income fell during this period; in 2000, it was 13 per cent lower than in 1980. The result was an effective arresting of the Third World Industrial Revolution, which is the name that Ajit Singh, the Cambridge economist, used in order to describe the economic development experience of developing countries in the first few decades following decolonization.

Only Chile did well out of neo-liberal policies of the 1980s and the 1990s, but at considerable human cost under the Pinochet dictatorship (1974–90).[30] All the other success stories of this period were economies that used state intervention extensively and liberalized only gradually. The best examples of this were Japan, the 'tiger' (or 'dragon', depending on your animal preference) economies of East Asia (South Korea, Taiwan and Singapore) and, increasingly, China.

The wall comes crashing down: the collapse of socialism

Then, in 1989, a momentous change happened. That year, the Soviet Union started to unravel, and the Berlin Wall was torn down. Germany was reunited (1990), and most Eastern European countries abandoned communism. By 1991, the Soviet Union itself was dismembered. With China gradually but surely opening up and liberalizing since 1978 and with Vietnam (unified under the Communist rule in

1975) also adopting its ‘open door’ policy (Doi Moi) in 1986, the socialist bloc was reduced to a few die-hard states, notably North Korea and Cuba.

The problems with the socialist economies were already well known: the difficulty of planning an increasingly diverse economy, incentive problems arising from weak links between performance and reward and widespread politically determined inequality in an ostensibly equal society (see Chapter 9). But few, including the most anti-socialist commentators, had thought that the bloc would implode so quickly.

The ultimate problem was that the Soviet bloc economies had tried to build an alternative economic system based on essentially second-rate technologies. There were, of course, areas like space and arms technologies where they were leading the world (after all, in 1957 the Soviet Union put the first ever man in space), thanks to the disproportionate amount of resources poured into them. However, when it became evident that it could only offer its citizens second-rate consumer products – as symbolized by Trabant, the East German car with plastic body, which quickly became a museum piece after the fall of the Berlin Wall – the citizens revolted.

In the next decade or so, the socialist countries in Eastern Europe made a headlong dash to transform themselves (back) into capitalist ones. Many thought that the ‘transition’ *could be* made quickly. Surely, it was just a matter of privatizing SOEs and reintroducing the market system, which is after all one of the most ‘natural’ human institutions? Others added that the transition *had to be* made quickly, in order not to give time to the old ruling elite to regroup itself and resist change. Most countries adopted ‘Big Bang’ reforms, trying to bring capitalism back overnight.

The result was nothing short of a disaster in most countries. Yugoslavia disintegrated and descended into wars and ethnic cleansing. Many former republics of the Soviet Union experienced deep depressions. In Russia, the economic collapse and the resulting unemployment and economic insecurity caused so much mental stress, alcoholism and other health problems that it is estimated that millions more people died than would have been the case if the pre-transition trends had continued.[31] In many countries, the old elite simply ‘changed their suits’ and transformed themselves from party *apparatchiks* into businessmen, enriching themselves hugely by acquiring state assets at knock-down prices through corrupt practices and ‘insider dealings’ in the privatization process. The Central European countries – Poland, Hungary, the Czech Republic and Slovakia – fared better, especially after they joined the European Union in 2004, thanks to being more gradualist in their reform and to their better skill bases. But even in the case of these countries, it is difficult to hail the transition experience as a great success.

The fall of the socialist bloc ushered in a period of ‘free-market triumphalism’. Some, such as the American (then) neo-con thinker Francis Fukuyama, pronounced the ‘end of history’ (no, not the end of the world) on the grounds that we had finally conclusively identified the best economic system in the form of capitalism. The fact that capitalism comes in many varieties, each with particular strengths and weaknesses, was blissfully ignored in the euphoric mood of the day.

One world, ready or not: globalization and the new world economic order

By the mid-1990s, neo-liberalism had spread throughout the world. Most of the old socialist world had been absorbed into the capitalist world economy, either through the ‘Big Bang’ reforms or, as in the case of China and Vietnam, through gradual but constant opening up and deregulation. By this time, market opening and liberalization had also progressed considerably in most developing countries. In most

countries, this happened rapidly due to the SAP, but there were some others where it happened more gradually through voluntary policy changes, such as in India.

Around this time, some important international agreements were signed that signalled a new era of global integration. In 1994, the NAFTA (North American Free Trade Agreement) was signed between the US, Canada and Mexico. It was the first major free-trade agreement between developed countries and a developing country. In 1995, the Uruguay Round of the GATT talks was concluded, resulting in the expansion of the GATT into the WTO (World Trade Organization). The WTO covers many more areas (e.g., intellectual property rights, such as patents and trademarks, and trade in services) and has more sanctioning power than the GATT did. Economic integration progressed further in the EU, with the completion of the 'Single Market' project (with the so-called 'four freedoms of movement' – of goods, services, people and money) in 1993 and with the 1995 accession of Sweden, Finland and Austria.* The combined result was the creation of an international trading system that was much more geared towards freer (although not entirely free) trade.

Also the idea of globalization emerged as the defining concept of the time. International economic integration of course had been going on since the sixteenth century, but according to the new globalization narrative, this process has reached an entirely new stage. This was thanks to the technological revolutions in communications (the internet) and transportation (air travel, container shipping), which were leading to the 'death of distance'. According to the globalizers, countries now had no choice but to embrace this new reality and fully open up to international trade and investments, while liberalizing their domestic economies. Those who resisted this inevitability were derided as the 'modern Luddites', who think they can bring back a bygone world by reversing technological progress (see above). Book titles like *The Borderless World*, *The World Is Flat* and *One World, Ready or Not* summed up the essence of this new discourse.

The beginning of the end: the Asian financial crisis

The euphoria of the late 1980s and the early 1990s didn't last. The first sign that not everything was fine with the 'brave new world' came with the financial crisis in Mexico in 1995. Too many people had invested in Mexican financial assets with the unrealistic expectation that, having fully embraced free-market policies and having signed the NAFTA, the country was going to be the next miracle economy. Mexico was bailed out by the US and the Canadian governments (who didn't want a collapse in their new free-trade partner) as well as by the IMF.

In 1997, a bigger shock came about with the Asian financial crisis. A number of hitherto successful Asian economies – the so-called 'MIT economies' (Malaysia, Indonesia and Thailand) and South Korea – got into financial troubles. The culprit was the bursting of the **asset bubbles** (asset prices rising well above their realistic levels, based on unrealistic expectations).

While they had been more cautious than other developing regions in opening up their economies, these countries opened up their financial markets quite radically in the late 1980s and the early 1990s. Now facing fewer restrictions, their banks borrowed aggressively from the rich countries, which had lower interest rates. In their turn, the rich-country banks saw little risk in lending to countries with decades-long excellent economic records. As more foreign capital flowed in, asset prices went up, which enabled firms and households in the Asian countries to borrow even more, using their now more valuable assets as collateral. Soon the process became a self-fulfilling prophecy, as the expectation of ever-rising asset

prices justified further borrowing and lending (sounds familiar?). When it later became clear that those asset prices were unsustainable, money was pulled out, and financial crises ensued.

The Asian crisis left a huge scar in the afflicted economies. In economies where 5 per cent growth (in per capita terms) was considered a 'recession', output *fell* in 1998 by 16 per cent in Indonesia and 6–7 per cent in the other economies. Tens of millions of people were thrown out of work in societies where unemployment means penury, given the small size of the welfare state.

In return for the bail-out money from the IMF and the rich countries, the crisis-stricken Asian countries had to accept a lot of policy changes – all in the direction of liberalizing their markets, especially their financial markets. While it pushed the Asian economies themselves on in a more market-oriented direction, the Asian crisis – and the Brazilian and the Russian crises that immediately followed it – actually planted the first seed of scepticism about post-Cold War free-market triumphalism. There were serious discussions about the need to reform the global financial system, much of them along the same lines as the ones that we have seen following the 2008 global financial crisis. Even many leading advocates of globalization – like the *Financial Times* columnist Martin Wolf and the free-trade economist Jagdish Bhagwati – started questioning the wisdom of allowing free international capital flows. All was not well with the new global economy.

The false dawn: from the dot.com boom to the Great Moderation

When these crises were brought under control, talk of global financial reform receded. In the US, a major push in the other direction came in the form of the 1999 repeal of the iconic New Deal legislation, the 1933 Glass-Steagall Act, which structurally separated commercial banking from investment banking.

There was another moment of panic in 2000, when the so-called dot.com bubble – in which internet-based companies with no prospect of generating any profit in the foreseeable future had their shares valued at absurdly high levels – burst in the US. The panic soon receded, as the US Federal Reserve intervened and cut interest rates aggressively and the central banks of other rich economies followed suit.

From then on, the early years of the millennium seemed to be going swimmingly well in the rich countries, especially in the US. Growth was robust, if not exactly spectacular. Asset prices (prices of real estate, company shares and so on) seemed to be going up forever. Inflation remained low. Economists – including Ben Bernanke, the chairman of the Federal Reserve Board between February 2006 and January 2014 – talked of the 'Great Moderation', in which the science of economics had finally conquered **boom and bust** (or the economy going up and down by large margins). Alan Greenspan, the chairman of the Federal Reserve Board between August 1987 and January 2006, was revered as the 'Maestro' (as immortalized in the title of his biography by Bob Woodward of Watergate fame) who had a near-alchemical skill in managing a permanent economic boom without stoking inflation or courting financial trouble.

During the middle years of the 2000s, the rest of the world finally started to feel the 'miracle' growth of China of the preceding two decades. In 1978, at the beginning of its economic reform, the Chinese economy accounted for only 2.5 per cent of the world economy.[32] It had minimal impact on the rest of the world – its share of world merchandise (goods) export was a mere 0.8 per cent.[33] By 2007, the corresponding numbers had risen to 6 per cent and 8.7 per cent.[34] Being relatively poorly endowed with natural resources and growing at breakneck speed, it started sucking in food, minerals and fuel from the rest of the world, and the effect of its growing weight was felt more and more strongly.

This gave a boost to the raw-material exporters of Africa and Latin America, finally allowing these economies to make up some of the ground they had lost in the 1980s and the 1990s. China also became a major lender and investor in some African countries, giving the latter some leverage in negotiating with the BWIs and the traditional aid donors, such as the US and the European countries. In the case of the Latin American countries, this period also saw a departure from the neo-liberal policies that had served them so poorly in several countries. Brazil (Lula), Bolivia (Morales), Venezuela (Chavez), Argentina (Kirchner), Ecuador (Correa) and Uruguay (Vasquez) were the most prominent examples.

A crack in the wall: the 2008 global financial crisis

In early 2007, alarm bells were rung by those who were worried about the (non-)repayment of mortgage loans that are euphemistically called 'subprime' (read 'having high chance of default'), made by US financial firms in the preceding housing boom. People with no stable income and chequered credit histories were lent more money than they could afford to pay back, on the assumption that house prices would keep going up. They would be able to repay their loans, it was reckoned, by selling their houses, if worse came to worst. On top of that, thousands or even hundreds of thousands of these high-risk mortgage loans were combined into 'composite' financial products, such as the MBS and the CDO (no need to know what they were at this stage – I will explain them in detail in Chapter 8) and sold as low-risk assets, on the assumption that the chance of a large number of borrowers simultaneously getting into trouble must be much lower than that for individual borrowers.

Initially, the problem mortgage loans in the US were estimated to be $50–100 billion – not a small amount but an amount that can be easily absorbed by the system (or so many claimed at the time). However, the crisis erupted properly in the summer of 2008, with the bankruptcy of the investment banks Bear Stearns and then Lehmann Brothers. A huge financial panic swept the world. It was revealed that even some of the most venerable names in the financial industry were in big trouble, having generated and bought huge numbers of dubious composite financial products.

The 'Keynesian spring' and the return of the free-market orthodoxy – with a vengeance

The initial responses of the major economies were very different from those following the Great Depression. Macroeconomic policies were Keynesian in the sense that they let huge budget deficits develop – at least not by cutting spending in line with falling tax revenues and in some cases by increasing government spending (China did this most aggressively). Major financial institutions (e.g., the UK's Royal Bank of Scotland) and industrial firms (e.g., GM and Chrysler in the US) were bailed out with public money. Central banks brought interest rates down to historical lows – for example, the Bank of England cut its interest rate to the lowest level since its foundation in 1694. When they could not cut their interest rates any more, they engaged in what is known as **quantitative easing** (QE) – basically, the central bank creating money out of thin air and releasing it into the economy, mainly by buying government bonds.

Soon, however, free-market orthodoxy came back with a vengeance. May 2010 was the turning point. The election of the Conservative-led coalition government in the UK and the imposition of the Eurozone bail-out programme for Greece in that month signalled the comeback of the old balanced budget doctrine. **Austerity** budgets, in which spending is cut radically, have been imposed in the UK and in the so-called PIIGS economies (Portugal, Italy, Ireland, Greece and Spain). The success of the Republicans in pushing the Obama government in the US to accept a huge spending cut programme in 2011 and the reaffirmation of the anti-deficit bias of the core European countries in the form of the European Fiscal Compact, signed

in 2012, pushed things even further in that direction. In all these countries, but especially the UK, the political right are even using the argument for balancing the budget as an excuse to severely prune back the welfare state, which they have always wanted to reduce.

The consequences: the lost decade?

The 2008 crisis has had devastating consequences, and its end is nowhere in sight. Four years after the crisis, at the end of 2012, per capita output remained lower than in 2007 in twenty-two of the thirty-four member countries of the OECD (Organization for Economic Cooperation and Development), the Paris-based club of rich countries (with a handful of developing country members).* GDP per capita in 2012, when filtering out the effect of price inflation, was 26 per cent below the 2007 level in Greece, 12 per cent below in Ireland, 7 per cent below in Spain and 6 per cent below in the UK. Even in the US, which is said to have recovered better than other countries from the crisis, per capita income in 2012 was still 1.4 per cent below the 2007 level.†

With the austerity budget, the prospect for economic recovery in many of these countries is dim. The problem is that a radical cut in government spending in a stagnating (or even shrinking) economy holds back recovery. We have already seen this during the Great Depression. As a result, it may take a good part of the decade before many of these countries can get back to what they used to be in 2007. They could well be in the middle of a 'lost decade', as was experienced in Japan (the 1990s) and in Latin America (the 1980s).

It is estimated that, at its depth, the crisis created 80 million extra unemployed people worldwide. In Spain and Greece, unemployment shot up from around 8 per cent before the crisis to 26 per cent and 28 per cent respectively in the summer of 2013. Youth unemployment is well over 55 per cent. Even in countries experiencing 'milder' unemployment problems, such as the US and the UK, official unemployment rates reached 8–10 per cent at their heights.

Too little too late?: prospects for reform

Despite the scale of the crisis, policy reforms have been slow in coming. Despite the fact that the cause of the crisis lay in excessive liberalization in the financial market, financial reforms have been rather mild and are being introduced very slowly (over several years, when the US banks had a year to comply with the much tougher New Deal financial reforms). There are areas of finance, such as the trading in overly complex financial products, in which even mild and slow reforms are not being introduced.

Of course, this trend could be reversed. After all, in both the post-Depression US and Sweden, the reforms came only after a few years of economic downturn and hardship. Indeed, the electorate in the Netherlands, France and Greece voted out pro-austerity parties in the spring of 2012; Italian voters did likewise in 2013. The EU has introduced some financial regulations that are tougher than what many people had imagined likely (e.g., financial transaction tax, cap on financial sector bonuses). Switzerland, frequently considered the haven of the super-rich, passed a law in 2013 preventing high rewards for top managers with mediocre performances. While there remains a lot more to be done in relation to financial reform, these are actually developments that would have been considered impossible before the crisis.

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