Neo-classical economics: A trail of economic destruction since the 1970s

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'...soon or late, it is ideas, not vested interests, which are dangerous for good or evil'.
John Maynard Keynes, closing words of *The General Theory* (1936).

Abstract
This paper argues that the international financial crisis is just the last in a series of economic calamities produced by a type of theory that converted the economics profession from a study of real world phenomena into what in the end became mathematized ideology. While the crises themselves started by halving real wages in many countries in the economic periphery, in Latin America in the late 1970s, their origins are found in economic theory in the 1950s when empirical reality became academically unfashionable. About half way in the destructive path of this theoretical tsunami – from its origins in the world periphery in the 1970s until today's financial meltdowns – we find the destruction of the productive capacity of the Second World, the former Soviet Union. Now the chickens are coming home to roost: wealth and welfare destruction is increasingly hitting the First World itself: Europe and the United States. This paper argues that it is necessary to see these developments as one continuous process over more than three decades of applying neoclassical economics and neo-liberal economic policies that destroyed, rather than created, real wages and wealth. A reconstruction of widespread welfare will need to be based on the understanding that what unleashed the juggernaut of welfare destruction was not 'market failure'; it was 'theory failure'. Being a résumé of a larger research project, the paper includes references to more detailed studies of these processes of 'destructive destruction'.

Contents

Introduction

Two institutions established soon after WW II provided the conditions for a thirty year period of unprecedented increase in human welfare: The 1947 Marshall Plan, in the end re-industrializing not only Europe but creating a *cordon sanitaire* of wealthy nations around the communist block from Norway via Southern Europe to Japan, and the 1948 Havana Charter which established the rules of international trade that made this industrialization plan possible.

Both institutions were based on a key insight from Secretary of State George Marshall's 1947 Harvard Speech announcing his plan: that civilization had always been built on a particular type of economic structure. 'The farmer has always produced the foodstuffs to exchange with the city dweller for the other necessities of life. *This division of labor is the basis of modern civilization.* At the present time it is threatened with breakdown.'[1]

[1] http://www.oecd.org/document/10/0,3746,en_2649_201185_1876938_1_1_1_1,00.html (italics added). Marshall's insight still holds. An important common element in the approximately 50 failed or failing

Industrialization became the marching order, and the Havana Charter organized world trade accordingly: as long as there was either an industrial plan or unemployment was present in a country it was possible to protect what the great liberal John Stuart Mill had promoted as 'infant industry protection'. Starting at the same time, this vision of industrialization formed the very core of classical development economics.[2]

At the same time, wise legislation following the 1929 financial crash had harnessed finance as the servant of production, and already in 1945 Roosevelt's advisor on science, Vannevar Bush, had given the West the task of pushing forward the 'never ending frontier of scientific knowledge' through continuous innovations.[3] With a tripartite political setting – a balance of countervailing powers – between big business, big labor, and big government, all pieces were in place for the formidable increased welfare and economic growth that followed over the next decades.

The vision that solidified in 1947 was not new, however, and not unique to the West. When Russian intellectuals some years after the 1917 revolution started analyzing communist economic policy, they found that it was essentially the same industrialization policy that had been followed under Sergei Witte, Minister of Finance under the last two tsars, but under a very different political regime. It is easily forgotten that during the 20th century this type of vision was shared along the whole political axis. Henry Ford's United States, Hitler, Stalin, and Western European Welfare States all had a common understanding of wealth creation in industrialization and mass production and – parallel – an understanding of the necessarily subservient status of the financial sector to that of production.

The 1947 vision was implicitly based on German economist Werner Sombart's definition of capitalism as a system of production containing three main elements: a) the entrepreneur, b) the modern state, and c) the technological system, i.e. Vannevar Bush' never ending frontier of scientific knowledge. These three main elements of successful capitalism were, however, extremely difficult to formalize, and gradually they all disappeared from economic theory. The new typical definition of capitalism became that of a system of private ownership where all coordination outside the firm is determined by the market. As Sombart's three elements disappeared from neoclassical economics, so did the qualitative understanding of economic growth and development. Economics came to be based on what Schumpeter called 'the pedestrian view that it is the accumulation of capital *per se* that propels the capitalist engine'. This, and the disappearance of Schumpeter's distinction between the monetary sphere ('the accounting units') and the real economy, opened the way for the present dominance of the financial sector over the productive sector.

The 1947 type of understanding had a very long history in Europe. American economic historian Richard Goldthwaite shows the historical importance of the dichotomy between raw materials and manufacturing in a recent book: what is generally seen as Europe's 'commercial revolution', Goldthwaite argues, was in fact a process of emulating other countries, one of import substitution: manufactured goods, that had previously been imported

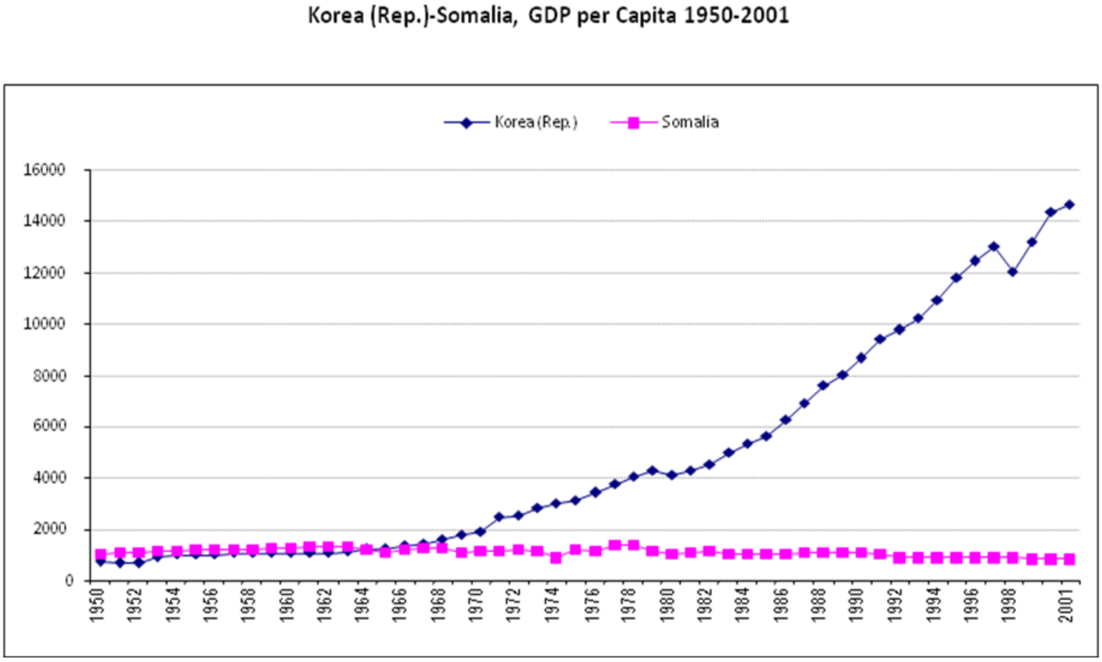
states today is that the manufacturing industry contributes less than six per cent of GDP (see Reinert, Kattel & Amaïzo quoted below.

[2] For a discussion, see Kattel, Rainer, Jan Kregel and Erik S. Reinert. *Ragnar Nurkse (1907-2007): Classical Development Economics and its Relevance for Today*. London: Anthem Other Canon Series, 2009.

[3] http://www.nsf.gov/od/lpa/nsf50/vbush1945.htm#transmittal

from the Levant started to be produced in Europe from the 12th century onwards. [4] A recent book documents that this process of emulation – rather than of comparative advantage – was the main strategy also of Enlightenment Europe.[5]

Figure 1: Comparing economic development in Somalia and Korea



Source: Reinert, Amaïzo and Kattel, 2009.[6]

The wealth and poverty of nations are still determined by the dichotomy between raw materials on the one hand and manufacturing and advanced services on the other. Figure 1 illustrates the explosive growth of South Korea, starting only in the very late 1960s, as that nation diversified its economy away from agriculture and raw materials and into manufacturing industry. Through very heavy-handed industrial policy, Korea broke away from its 'comparative advantage' in agriculture. By comparison, Somalia – being richer that Korea until the mid-1960s – did not, and instead continued to specialize according to its comparative advantage in being poor.

Understanding this extremely important distinction – between raw materials subject to diminishing returns, monoculture, and perfect competition on the one hand, and manufactured goods and advanced services subject to increasing returns, dynamic imperfect competition, and a large division of labor on the other – was the economic basis for Stalinism, for the Marshall Plan and Keynesian social democracy in Western Europe following World War II, and for US capitalism. The trail of economic destruction that has sequentially hit the world

[4] Goldthwaite, Richard (2009). *The Economy of Renaissance Florence.* Baltimore: Johns Hopkins University Press, pp. 6-8.

[5] Reinert, Sophus, *Translating Empire, Emulation and the Origins of Political Economy,* Cambridge, MA, Harvard University Press, 2011.

[6] Reinert, Erik S., Yves Ekoué Amaïzo and Rainer Kattel 'The Economics of Failed, Failing and Fragile States: Productive Structure as the Missing Link', in Kahn, Shahrukh Rafi & Jens Christiansen *Towards New Developmentalism: Market as Means Rather Than Master,* London: Routledge, 2010, pp. 59-86. WP version http://tg.deca.ee/eng/working_papers/

since the mid-1970s is largely the result of neo-classical economic theory ('mainstream economics, 'standard textbook economics') which – by destroying economics as an empirical science – unlearned the wisdom of close to 800 years of economic policy and also the former common understanding of wealth creation from the United States on the right to the USSR on the left.

The problem: unlearning the activity-specific element of economic growth and welfare

Economic growth for most of the 20th century was based on standardized mass production, what is also called *Fordism*. Henry Ford used to say that 'you can have the car in any colour you like as long as it is black'. Also the Soviet Union depended on mass production, and in communist China everyone even dressed alike. As indicated there was an important isomorphism – an element of strong structural similarity – along the political right-left axis: all successful 20th century societies were based on the same standardized industrial mass production. As Goldthwaite points out, industrialization, albeit on a much smaller scale, has been the one factor of success that built Europe. This had been recognized very early in practical policy, during the late 1400s, in England. The theoretical explanation came in 1613 with Italian economist Antonio Serra[7], whose theory of economic development based on increasing returns and a large division of labor was quoted by the main industrial theorist of the 19th century, German economist Friedrich List, and also by Marx. List not only inspired US and continental European economic policy, he also inspired Russian Finance Minister Sergei Witte – already mentioned – who translated List's work from German into Russian. For an important early link between Friedrich List and Marxist understanding of the importance of industry, see Szporluk (1991)[8].

For most of the 20th century, then, advanced nations left and right all followed the same industrialization strategy. David Ricardo's free trade theories based on comparative advantage were in practice only used towards the colonies. While the United States insisted on Ricardian trade theory and standard textbook economics as the foundation for the world economic order, Paul Krugman complained as late as the 1990s that US own trade policy failed to follow the principles of Ricardian trade theory:

'the view of trade as a quasi-military competition is the conventional wisdom among policy-makers, business leaders, and influential intellectuals…It is not just that economics has lost control of the discourse; the kind of ideas that are offered in a standard economics textbook do not enter into that discourse at all…'[9]

Just like with David Ricardo's theories in 19th century England, the US Washington Consensus free trade theories were for a long time mainly intended for export, not for use at home. Unfortunately, in the end the West also started believing in the propaganda version of its own economic theory.

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[7] Serra, Antonio, *A 'Short Treatise' on the Wealth and Poverty of Nations (1613),* ed. Sophus A. Reinert, London: Anthem Other Canon Series, 2011.

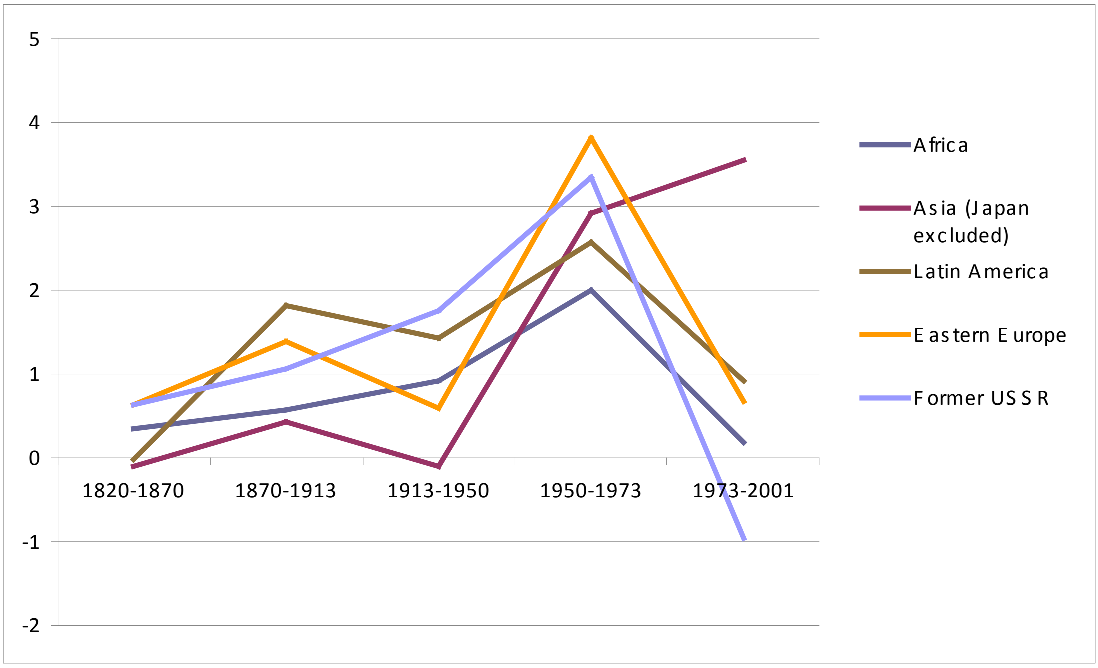
[8] Szporluk, Roman, *Communism and Nationalism: Karl Marx Versus Friedrich List,* Oxford: Oxford University Press, 1991.

[9] Quoted in Reder, Melvin, *Economics. The Culture of a Controversial science*, Chicago: University of Chicago Press, 1999, p. 6

A creeping mathematization and formalization of economics took place after World War II. Economics became 'social physics' based on late 19th century physics. With this development the distinction between industry and the production of raw materials – between increasing returns and large synergies on the one hand and diminishing returns and monoculture on the other hand – became blurred and disappeared. Increasing returns was thrown out of economic theory because it was not compatible with equilibrium; instead equilibrium should have been thrown out as the centrepiece of economics because it is not compatible with reality. Traditional development economics disappeared and The Washington Consensus slowly took over. Technological change, increasing and diminishing returns, and entrepreneurship disappeared from economic theory, obliterating any signals of dangers of a de-industrialization. In short: with the coming of neo-classical economics and neoliberalism all economic activities came to be seen as being qualitatively alike, in sharp contrast to the immediate post-WW II axis between the US and the USSR referred to above.

Economics *de facto* returned to the 'colonial' postulates of David Ricardo: that the international economy could and ought to be based on nations bartering labour hours: What a nation produced – industrial high-technology or subsistence agriculture – did not matter. On top of this, the World Bank and the International Monetary Fund started assuming full employment in all their models. Even if only 10 or 20 per cent of the potentially economically active population in a country actually had a job, full employment was assumed. This cruel Washington Consensus postulate made it possible to launch and continue the devastating shock therapies that hit The Third World and then The Second World. Only now 'the chickens are coming home to roost' as the American saying goes: only now, as the wave of destruction of neo-classical economics hits the United States and Europe through de-industrialization and financial crisis.

Figure 2: Development economics lost:
Growth rate of GDP per capita of selected world regions; regional average in selected periods between 1820 and 2001; annual average compound growth rate



Source: Kattel, Kregel and Reinert (2009). Original data from Maddison 2003.

Figure 2 shows the excellent world development record from 1950 until 1973, compared to the dismal performance following from 1973 to 2001. During this period Latin America experienced a string of 'lost decades', Africa's beginning industrialization was reversed, and The Second World – the communist planned economies – experienced a free trade shock that made them poorer than they had been under a notoriously inefficient planned economy. The old truth was once again revealed: a nation with an inefficient manufacturing sector is much better off than a nation without any manufacturing sector at all.

As can be seen from Figure 2, only Asian nations continued to be successful. Asia was largely unaffected by the free trade shock and continued their industrialization strategies, that in India and China had started already in the late 1940s. In fact, if India and China with their huge populations are removed from the data sets, globalization has been more a failure than a success. As we shall see later, this is even more so if we look at this development in terms of real wages rather than in terms of GDP per capita (because wages as a percentage of GDP have been reduced across the board).

From the mid-1970s: The Washington institutions chasing and destroying 'rents' in the productive sector only to re-create them in the financial sector

Since its very inception in the late Middle Ages, capitalism has been a process of what economists call 'rent seeking': through incessant invention and innovation capitalists have sought above average profits, also called rents. The early successful capitalist societies – Venice, the Dutch Republic, and England – all built their wealth on three types of rent. 1. They dominated the manufacturing sector in Europe, achieving the rents from increasing returns that are absent in agriculture. 2. They collected rents from dominating long-distance colonial trade, and 3. They all collected rent from dominating the market for a natural resource: salt in Venice, pickled – or salted – herring in the Dutch Republic, and wool in England. In all cases the raw materials went into manufacturing.

In a modern economy rents from oligopolies and innovations spread first as increased profits to the entrepreneur, then as higher wages to an increasingly skilled labor force, and then as higher taxable income to the state. In effect the system becomes one of triple rent-seeking: capital, labor, and government collude to share the oligopolistic rents. Minimum wages are an important tool for insuring such a 'collusive' distribution of the rents from innovations. In other words, rent-seeking in a sea of oligopolistic competition is what capitalism is all about. As labor also became oligopolistic through unionization, John Kenneth Galbraith described capitalism at its best – as in the US in the decades following World War II – as a system of countervailing powers of *big business*, *big labor*, and *big government.* Emulating the West, the Soviet Union attempted to create the same type of rents from the very same industries and economic activities – from steel and car production to space travel – that dominated in the United States. The best years of capitalist growth and the best years of growth of planned economy were based on the old idea – dating from Antonio Serra in 1613 – that economic growth and welfare were *activity-specific*, at any point in time they were produced by certain economic activities. Appendix 1 shows the qualitative differences between economic activities that are good for economic development (Schumpeterian activities) and those that are bad for economic development (Malthusian activities).

The same best years of growth were found in the Nordic countries, which were long seen as a very successful Third Way between capitalism and communism. The Swedish case is interesting because the formula for industrial success after WW II can be personified in three individuals, Schumpeterian economist Erik Dahmén (1916-2005), who for decades worked for *Stockholms Enskilda Bank,* the bank's owner Marcus Wallenberg (1899-1982), and social democratic politician Gunnar Sträng (1906-1992). Sträng held ministerial posts in the Swedish government from 1947 until 1976, the last 21 years as Minister of Finance. Industrialist Wallenberg and his advisor Dahmén had lunch every Wednesday, and capitalist Wallenberg and social democrat Sträng met, often in secrecy, to solve the big issues. This type of arrangement developed the Fordist wage regime – that the fruits of industrial productivity were shared between capital and labor – and the accompanying ratchet wheel effect of welfare capitalism: wages could only go up, not down. Steadily increasing wages – the fact that capital steadily became cheaper compared to labor – provided a key engine of growth in the golden decades of economic growth.

That wages were irreversible in monetary terms – the ratchet wheel effect – also had an important positive effect during what Hyman Minsky correctly called a financial crisis: the so-called 'oil crisis' of the 1970s. During this crisis the monetary policy of the Federal Reserve under the leadership of Arthur F. Burns – from 1970 to 1978 – was expansive, and the end result was that the purchasing power of wages and salaries was maintained during the crisis while negative real interest rates forced money out of banks and into productive investments in the real economy. Neo-classical economists, with their excessive emphasis on monetary stability rather than the stability of the real economy (Keynes' 'tyranny of the general price level'), tend to look on Burns as a failure. Compared to what we are seeing during this financial crisis – demand collapsing from austerity and the financial sector benefitting from debt deflation – Arthur F. Burns' solution is vastly to be preferred. Burns was a student of Wesley Clair Mitchell, the business cycle theorist, who again was a student of Thorstein Veblen, who rightly can be characterized as a precursor of Keynes.[10]

As an economist of the old institutional school, Arthur Burns was aware of the risk of using equilibrium economics when what was really happening was something entirely different, namely cumulative causations. Burns' words from 1954 apply extremely well to the Western world today:

'The warnings of a Marx, a Veblen, or a Mitchell that economists were neglecting changes in the world gathering around them, that preoccupations with states of equilibrium led to tragic neglect of principles of cumulative change, went unheeded.'[11]

Everywhere economic theory came to follow the same path of least mathematical resistance towards equilibrium as being the only dominating metaphor: the key factors that could not be formalized and mathematized – factors that determine the qualitative differences between economic activities in Appendix 1 and factors that create financial crises – were just left out of the theoretical edifice of economics. At present Western democracies have largely unlearned how their own countries got rich, and this lack of knowledge jeopardizes recovery.

During the years of Western triumphalism that followed the fall of the Berlin Wall all vestiges of capitalist moderation, e.g. those contained in the teachings of Thorstein Veblen, John

[10] See L. Randall Wray, "Veblen's Theory of Business Enterprise and Keynes' Monetary Theory of Production", in Reinert, Erik S. and Francesca Viano (eds.), *Thorstein Veblen: Economics for an Age of Crises*, London: Anthem Other Canon Series, forthcoming 2012.

[11] Arthur F. Burns, *The Frontiers of Economic Knowledge,* Princeton: Princeton University Press, 1954, p. 46.

Maynard Keynes, and Karl Polanyi, were gradually abolished. The present financial crisis is a direct result of an intellectual arrogance where things that could not be modeled by the tools chosen by the mainstream gradually came to be seen as irrelevant. The huge rents collected today by the financial sector are made possible by the assumptions on which neo-classical economics is built and which produce the 'flaws' of the model: the rents presently collected by the financial sector are in effect assumption-based rents.

It is now generally recognized that Hyman Minsky provides the best modern understanding of financial crises. But when present chairman of The Federal Reserve, Ben Bernanke, wrote a book about the 1929 crisis and the Great Depression a few years back, he mentions Hyman Minsky only once, and that just to dismiss him. This because Minsky 'had to depart from the theory of rational economic behavior'.[12] During the last 30-40 years being a mainstream economist has meant not to accept mechanisms that doubtlessly are hugely important, on the grounds that these mechanisms were in conflict with the fundamental assumptions of standard economic theory. In this way even the people with the main responsibility for handling the crises were gradually isolating themselves from the most relevant theories explaining it.

Neo-classical economics starts from assumptions of 'perfect competition', 'perfect information', and 'perfect foresight'. This is a situation where it is difficult for a company to make money, a situation – including the assumption of diminishing returns – that reflects the reality of Third World countries rather than that of First World ones. Not understanding that capitalism is about collecting innovation-based rents, the World Bank and IMF spent almost 40 years destroying production-based rent in the world periphery – from Peru via Russia to Mongolia and now the West itself – while tilting the playing field towards financial rents. Existing industrial rents were largely destroyed by premature shock liberalization, but – as we shall see in Figure 6 – this policy instead led to rapidly increasing rents in the financial sector.

Figure 3 shows how real wages in Peru were more than halved when the free trade shock and subsequent de-industrialization hit the country starting in the mid-1970s. The vocabulary now pertaining to the policy of wage destruction was also invented here: in Peru the year 1978 was officially named "The Year of Austerity" (*Año de la Austeridad*). Seen from the Washington Institutions the story could be presented as one of success because exports were skyrocketing. In reality the income of the average person was more than halved. I have also, in detail, documented a very similar process of de-industrialization and halving of real wages in Mongolia starting in the early 1990s.[13]

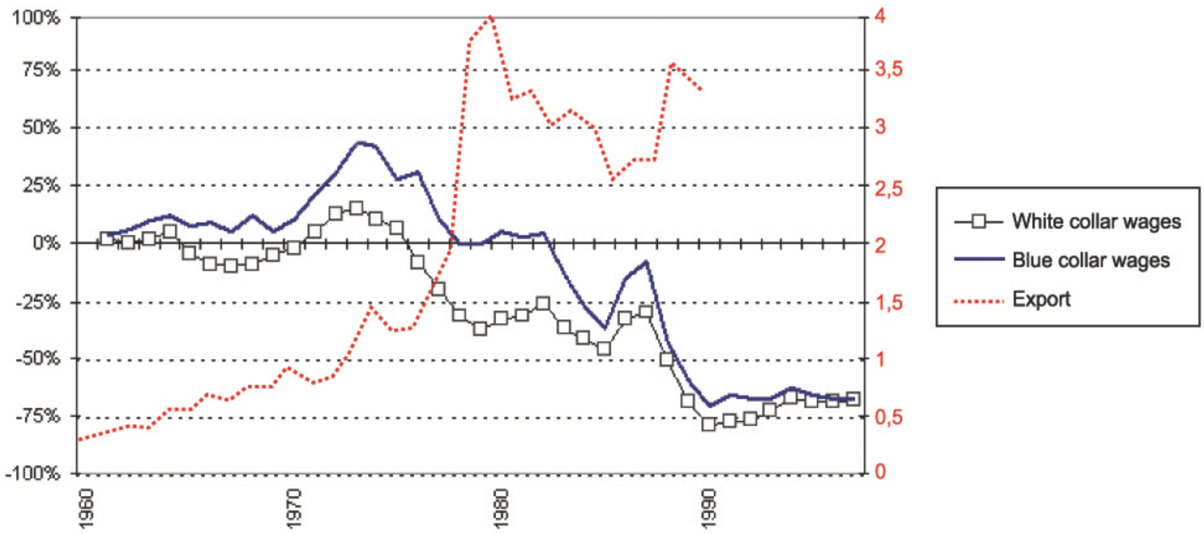
Presently financial markets have collapsed also in the West, and even the United States finds that too much free trade has undermined its manufacturing base, and that the lack of purchasing power of the common man is a main obstacle to recovery and increased employment. In an attempt to recover – having unlearned the essential Keynesian paradox of thrift – the West embarked on the same austerity-based attack on purchasing power and wage levels that had previously been employed in Peru and other Latin American countries

[12] Bernanke, Ben S. (ed.), *Essays on the Great Depression.* Princeton: Princeton University Press, 2000, p. 43.

[13] Reinert, Erik S., 'Globalisation in the Periphery as a Morgenthau Plan: The Underdevelopment of Mongolia in the 1990's', in Reinert, Erik (ed.), Globalization, Economic Development and Inequality: An Alternative Perspective, Cheltenham: Edward Elgar, 2004, pp. 157-214.
http://www.othercanon.org/papers/

and later in the Second World. The results promise to be just as devastating to real wages and purchasing power in the West as it has been elsewhere.

Figure 3: Industrialization, de-industrialization and falling real wages in Peru



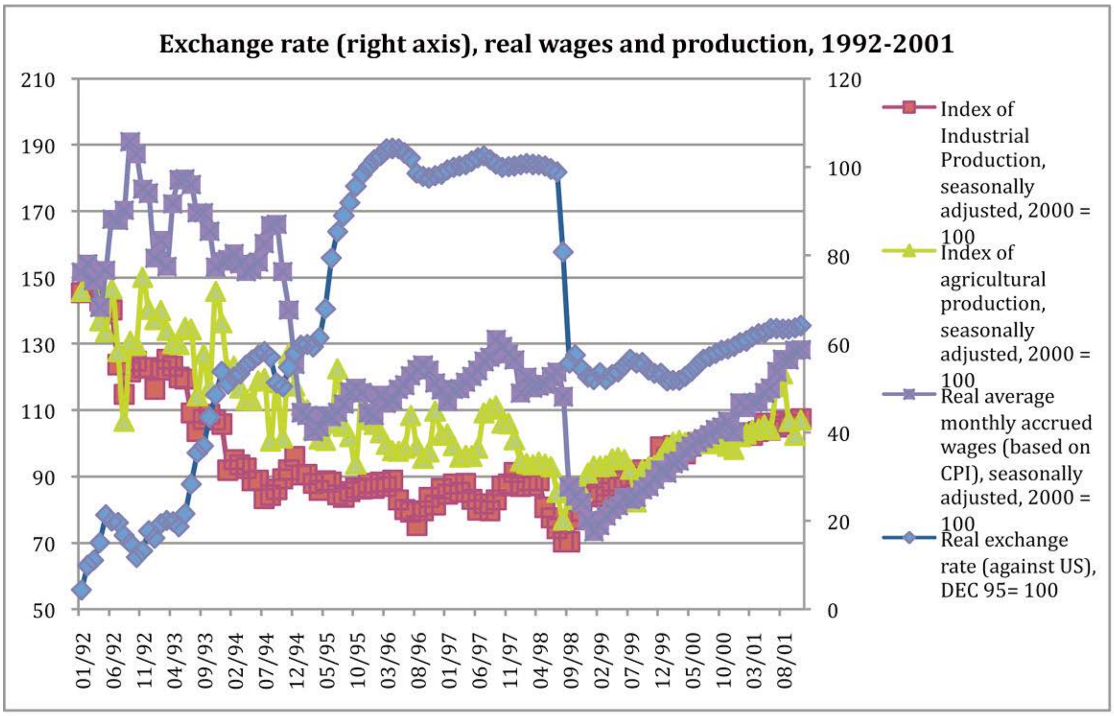
Source: Reinert 2007.[14]

The de-industrialization of large parts of Latin America and of the little industry that had been created in Africa started during the mid-1970s. The de-industrialization of the Second World started more than 20 years later, after the fall of the Berlin wall. A third wave of destruction was represented by the financial crises starting in Asia in the summer of 1997 and in Russia in the summer of 1998. These crises provided a dress rehearsal for the crises that would hit the capitalist core, the United States and Western Europe, 10 years later. An important element in Figure 3 is the apparent success of exports accompanied by collapsing wages. A similar pattern of increased exports accompanied by falling wages can now be observed in the EU periphery, normally reflecting a deterioration of the Terms of Trade.

Part of the same problem as the Asian Crisis was the 1998 collapse of Long-Term Capital Management (LTCM) in the United Sates, losing 4.6 billion dollars in less than 4 months. However, these two warnings showing the mechanisms of economic collapse were never seen as signs that something could be wrong with the economic system and economic theory. The Asian crisis was seen as a result of 'Asian values' and 'crony capitalism', not of any weakness in the structure of capitalism or in economic theory. LTCM Board of directors members included Myron Scholes and Robert C. Merton, who – ironically enough – shared the Nobel Memorial Prize in Economic Sciences a few months into the Asian crisis, in 1997. Instead of seeing the writing on the wall, the economics profession blindly gave its most prestigious reward to the creators of financial tools which investment Guru Warren Buffet later would call 'time bombs' and 'financial weapons of mass destruction'.

[14] Reinert, Erik S., *How Rich Countries got Rich… and why Poor Countries stay Poor*, London: Constable, 2007.

Figure 4: Exchange rates and falling real wages and production in Russia, 1992-2001.



Source: Reinert & Kattel (2010).[15]

Figure 4 shows the destruction of the productive structures and real wages in Russia, starting with the neoliberal shock therapy of 1992. Industrial production was reduced by more than 50 per cent, and real wages by almost 50 per cent. Note that agricultural production took a similar destructive dip. It is also important to note the important role which must have been played by the huge overvaluation of the rouble. Only with the massive devaluation in the fall of 1998, production and wages started to recover.

In the 1930s the crisis was solved through 'trade wars' which created employment. During the present crisis the equivalent is 'currency wars', which mainly cause financial gains from speculation. The damage created to national productive structures by artificially high exchange rates – as in Greece and other countries in the EU periphery – can be read off in the Russian graph in Figure 4. This further contributes to a phenomenon discussed in the next section: the growth of the financial sector as a percentage of GDP at the expense of the production sector.

Resurrection as post-industrial feudalism?

The first wave of neo-classical wealth destruction hit most of Latin America starting in the mid-1970s. At the same time Africa started losing the little industry the continent had managed to build. The second big wave of destructive destruction hit the Second World after the 1989 fall of the Berlin Wall. The present economic crisis in the European Union started in the Baltic countries, and was fundamentally caused by the long-term effect of the severe de-

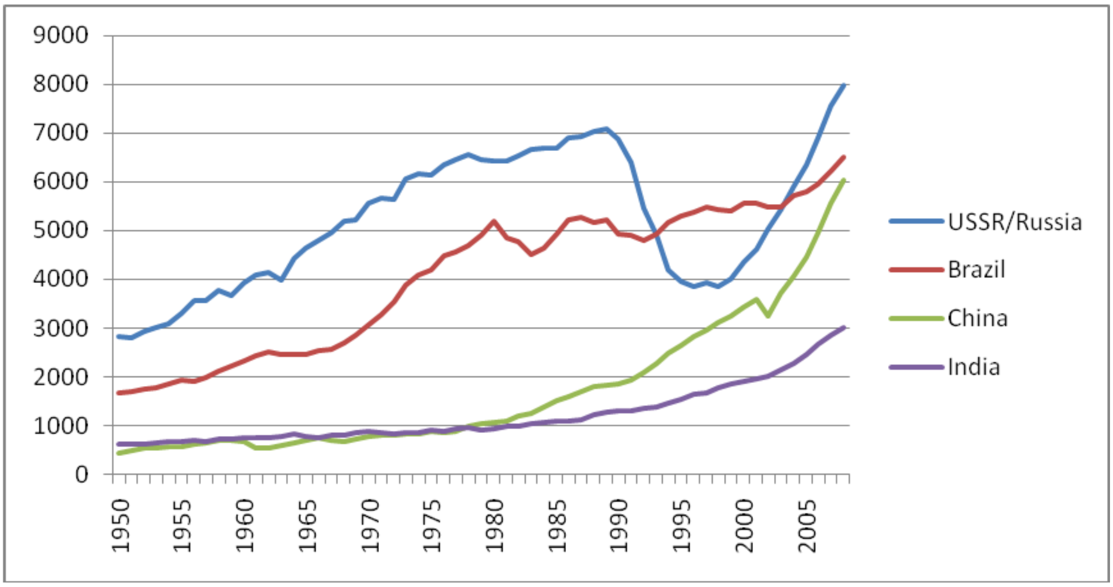
[15] Reinert, Erik S. & Rainer Kattel (2010), 'Modernizing Russia: Round III. Russia and the other BRIC countries: forging ahead, catching up or falling behind?' http://tg.deca.ee/files/main/2010090707562222.pdf

industrialization of those countries that took place in the early 1990s, coupled with the refusal to adjust the exchange rate in order to save the productive structure rather than to save the banks.[16]

Now seemingly country after country in Europe, starting with Greece, become victims of the same pattern of de-industrialization and overvalued currencies. It is surprising that Germany seems not to have learned the lessons regarding overvalued currencies that emerge so clearly from the 1990 unification of the two Germanies. While the market exchange rate between the *Westmark* and *Ostmark* – the currencies of West and East Germany respectively – at the time was one *Westmark* for three *Ostmark*, with the unification wages were converted at the rate of one to one. This made economic activity in the former East Germany uncompetitive, which in turn a) forced people to move from the East to the West, and b) made the unification process – raising the standards of living in the East – immensely expensive. The same mechanisms are presently at work in Greece.

Only few nations outside the core of capitalism – Western Europe and North America – escaped the waves of destruction of the 1970s and 1990s. Only now, with the failure of mainstream economics to clearly distinguish between the financial sector and real wealth creation, are Western Europe and North America being hit by the destructive destruction of neo-classical economics. Figure 5 shows how the presently very successful BIC countries – Brazil, India, and China – escaped virtually unhurt from the free market fundamentalism and free trade shock that accompanied the fall of the Berlin Wall, what one author dubbed 'the end of history'. The experience of the BRIC countries contrasts sharply with the massive welfare destruction that hit the USSR/Russia.

Figure 5: Per capita GDP in selected countries: 1950-2008, in 1990 international dollars: USSR/Russia, Brazil, China, and India.



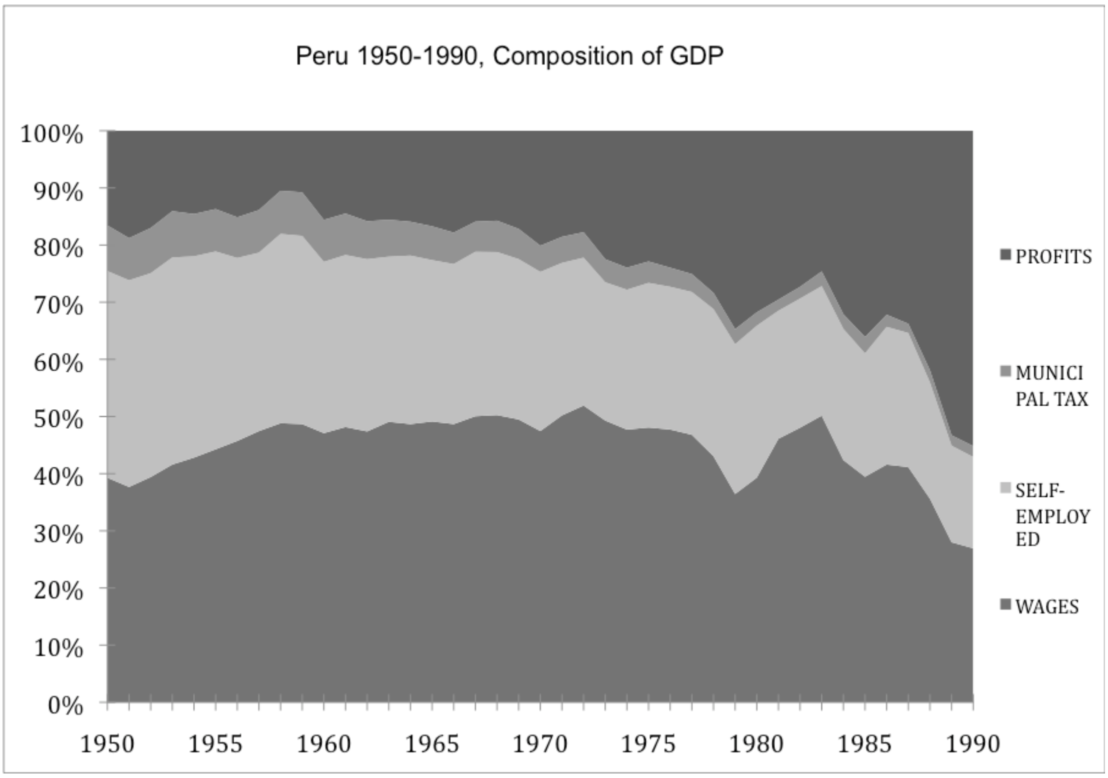
Source: Angus Maddison (2003) and The Conference Board and Groningen Growth and Development Centre, Total Economy Database, June 2009, http://www.conference-board.org/economics/

[16] Reinert, Erik S & Rainer Kattel (2007). 'European Eastern Enlargement as Europe's Attempted Economic Suicide? http://tg.deca.ee/files/main//2007070309122525.pdf

The main difference between the BIC countries (Brazil, India and China) on the one hand and the USSR/Russia on the other lies in the speed of trade liberalization. India and China only slowly opened up the system of industrial protection that had been in place since the late 1940s. No doubt both China and India had protected their industries too long. The difference in the curves in Figure 5 shows, however, the extreme risk of opening up for free trade too early rather than too late.

Brazil's 'economic miracle' started only in the 1960s and early -70s, but since then both the Brazilian economy and Brazilian development ideology have been out of synch with the rest of the Western Hemisphere. While the smaller Latin American countries could not escape the clutches of a market fundamentalism that destroyed state capacities and economic institutions which are needed for economic development, Brazil escaped relatively unharmed. Like India and China, Brazil was protected by institutional inertia and a large diversity of economists. There neoliberalism met with a critical mass of resistance from economists of other persuasion than the neo-classical one. The huge Brazilian development bank, BNDS – which now has a larger capital base than the World Bank – continues to play a decisive role in Brazil's growth.

Figure 6: Peru: De-industrialization and wages falling as a share of GDP: 1950-1990.

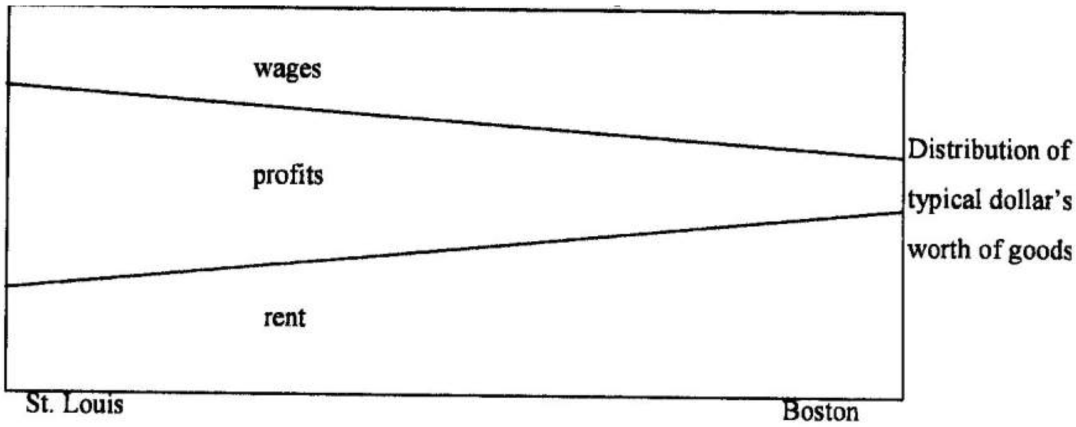


Legend, from top, profits, pre-dial (tax), income of the self-employed, wages.
Source: *Banco Central de Reserva del Perú*. Breakdown of GDP by source has not been published after 1990.

Figure 5, which compared the BRIC countries, indicates that Russia may have recovered lost territory. However, the countries that had been through the shock therapy of de-industrialization continued on a different growth path than before, regardless of being formerly capitalist or formerly planned economy. The mass destruction of industry destroyed the rents for a huge number of industrial workers and middle class office employees. The GDP of these de-industrialized countries went through a structural transformation in which wages and income of the self-employed radically shrank as a percentage of GDP, while the FIRE sector (Finance, Insurance, and Real Estate) grew rapidly. Figure 6 shows this national redistribution of income from labor to capital in the case of Peru. This is a pattern of income distribution that reminds one more of feudalism than of an industrial society, and which hides huge social problems.

In many ways, the United States can be seen as the prototype successful developmental state. US economist Henry Carey (1793–1879) insisted that trading too much with Britain would preclude the United States from enjoying the bounties of future technological change. Carey also devised what he called a 'commodity map', which illustrates how the presence of a manufacturing sector changes the way income is distributed within a nation. Carey's map, which could also have been called a 'development synergy' map, is an illustration of the centuries-old observation of the effects of a manufacturing sector. Today, the map can be used to explain the mechanisms that led to the structural changes in income distribution that we observe in Peru in Figure 6, the mechanisms by which Washington Consensus policies increased poverty in the world periphery. I suggest Figure 6 may also represent the structural change presently taking place in the West, and which occurred with the large dip in Russian GDP shown in figure 4. The Russian resurrection of growth was accompanied by a new income distribution where the FIRE sector had grown very much.

Figure 7: Henry Carey's 'Commodity Map' (1858)[17]



(Modified from Carey 1858a, iii, p. 187]

Figure 7 represents the breakdown of a typical dollar's worth of goods, i.e. a proxy for what we would call output or GDP. The height of the graph represents 100 per cent of GDP. Carey shows how different the composition of GDP was in the developed East compared to the undeveloped West of the United States at the time; the graph indicates how the composition of output changes as one moves gradually from Boston to St. Louis – from right to left in the figure – or vice versa. Economic development – increasing the division of labor and manufacturing – is represented by moving east from St. Louis, Missouri towards Boston. Poverty and backwardness grow as one moves west from Boston to St. Louis. St. Louis thus represents the situation in the undeveloped world or periphery today. Here, raw materials – e.g. cotton or cattle – are produced; land is abundant and cheap, labor is unskilled and cheap,

[17] Source: Perelman, Michael (2002). 'The Comparative Sociology of Environmental Economics in the Works of Henry Carey and Karl Marx', *History of Economics Review*, 36, Summer: 85-110.

tasks are simple, and the division of labor is limited. Under such conditions, Carey says, profits take up a large share of the GDP.

The East, Boston, represents today's developed world with a large division of labor that adds a lot of value to a raw materials base. In the East, in contrast to the underdeveloped West, a multitude of workers combine their efforts within a complex social division of labor to work raw materials into ever more sophisticated products. More skills are required, increasing returns create higher profits and higher barriers to entry. Here, wages and rents form a much larger portion of the value of products, while profits shrink to a smaller percentage of GDP. The shock therapies from Latin America to Russia and Mongolia created a structural economic change that corresponds to travelling from Boston to St. Louis in Carey's diagram.

If a nation should move over time from Boston to St. Louis, that means undoing the synergies of development, reversing the critical mass that creates wealth, in a sense travelling from capitalism back in time towards something resembling feudalism in a post-industrial variety. This more than 150 year old graph shows how Washington Consensus policies that started in the late 1970s have produced the same regressive effect as Henry Carey claims moving from Boston to St. Louis would have done in 1858: wages as a percentage of GDP sank slowly, while rents and profits – the FIRE sector: finance, insurance and real estate – grew correspondingly.

The solution: Back to basics, resurrecting the alternative canon of economics

Perhaps the best metaphor for today's economic situation in the West is that of Walt Disney's Uncle Scrooge and his bin of unproductive money (what the Bible refers to as 'mammon') representing a growing part of the financial sector. Scrooge's money is idle, and he only uses it for bathing purposes. Imagine Scrooge having lent money to Greece and other countries, and the debt payments – while causing the Greek economy to shrink – only accumulating as a bigger bin of ide money in which Scrooge swims. Presently our efforts to 'save' Greece and other countries only cause transfers of money from one bin of idle money to another: it does not reach Greece and its people whom we are pretending to save. As Francis Bacon said already 400 years ago: 'Money is like muck, not good except it be spread'.

Neo-classical economics – not distinguishing between the financial economy and the real economy – tends to see this destruction of real wealth and accumulation of idle capital merely as an innocuous market activity. Neoliberalism in practice meant financial capital hijacking the market rhetoric in order to re-enact what seems to be developing into a modern version of debt slavery. This is the same problem democracy was not able to handle in the 1930s. Karl Polanyi suggests that the systems that emerged during the crisis of the 1930s were similar only in disregarding *laissez-faire* principles. Indeed, we can observe that the most important thing communism, fascism, and Roosevelt's New Deal had in common was that they all saw the need to reign in the financial sector to become the servant rather than the master of capitalist development.

The situation facing the world in 2012 is in many ways also similar to that which faced the world in the revolutionary year 1848. Free trade economics had triumphed in 1846 with the Repeal of the Corn Laws, but victory was to be short-lived. Widespread social problems and a massive financial crisis in 1847 had prepared the ground for revolutions in all large European countries with the exception of England and Russia, in 1848. The enemy then was

Manchester-liberalism based on the free trade theories of David Ricardo, a very similar movement to today's neoliberalism. Manchester-liberalism and neoliberalism both threat to undo the wealth-creating synergies of an industrialized economy.

The revolutions of 1848 produced two politically extreme positions, two utopias: communism and Manchester-liberalism. But by the mid-1890s the economics profession in Europe had rid itself of both political extremes. The victory of the middle ground was well described by German economist Gustav Schmoller in his 1897 inaugural speech as Rector of the University of Berlin:

'The simplistic optimism of 'laissez-faire' and the childish and frivolous appeal to revolution, the naive hope that the tyranny of the proletariat would lead to world happiness, increasingly showed their real nature, they were twins of an ahistorical rationalism…. The old doctrines of individualistic natural law were transformed from the humanistic idealism of an Adam Smith to the hard mammonism of the Manchester School and (were useless for the present situation)… The period 1870-1890 led to the theoretical and practical bankruptcy of both the old schools'.

Again the task is to recuperate the middle ground. Of the three political systems which brought financial capital under control during the 1930s – communism, fascism and The New Deal – there is little doubt what most people today would choose. But is that an option as long as neo-classical economics – the useful fools of the financial sector – virtually monopolizes Western universities? Starting in the 1970s neoliberalism – the 'Manchester School' – once again showed its destructive powers. After waves of destructive destruction, first in the Third World, then in the Second – former communist world, the turn has come to the First World, to the West itself. We again ought to remember the lesson from Gustav Schmoller and the Historical School of Economics that he founded, the school that created the Western European welfare state. Several wheels do not have to be reinvented. The principles of the Havana Charter – unanimously approved by the members of the United Nations in 1948 – can also in today's context serve as a blueprint for a world economic order that creates, rather than destroys, mass welfare.

In the triumphalism that followed the fall of the Berlin Wall, both the political middle ground and its successful tools for welfare creation were lost to an economic theory largely based on what Schumpeter described as the Ricardian Vice: Applying severely simplified abstractions to the solution of practical problems. Or, as my colleague Wolfgang Drechsler calls it: 'irrelevance as methodology'.

If the American Dream is to be recaptured, it cannot be done without resurrecting the kind of economic understanding which, from 1820 onwards, created American industrialization, but in a new and present context. One place to start understanding what went wrong in Europe is to contrast the gradual and successful integration of Spain into the EU during the 1980s – based on the principles of Friedrich List – with the failure of de-industrializing shock therapies applied to the Baltic countries first in the 1990s, and then with the 2004 EU integration.

There is a political middle ground to be recaptured, and with it another canon of economics than the one represented by neo-classical economics and the Washington Consensus. This experience-based canon must also – as did Schumpeter and many others – distinguish the real economy from the financial sector, seeing that, if unregulated, the symbiosis that in good times exists between the financial sector and the real economy may develop into a situation where the financial sector no longer adds value to the real economy, but parasitically destroys value, as countries from Greece to the United States are now experiencing.[18] In this other canonical tradition economic activities are qualitatively different, and this understanding forms the necessary foundation for creating national wealth. A whole tradition – a qualitatively different way of thinking – needs to be rediscovered, resurrected, and applied to economic policy.

Appendix 1: Schumpeterian and Malthusian Economic Activities

Characteristics of <u>Schumpeterian activities</u> (= 'good' export activities)	**Characteristics of <u>Malthusian activities</u> (= 'bad' export activities if no Schumpeterian sector present)**
Increasing returns	Diminishing returns
Dynamic imperfect competition ('rent-seeking')	'Perfect competition' (commodity competition)
Stable prices	Extreme price fluctuations
Generally skilled labor	Generally unskilled labor
Creates a middle class	Creates a 'feudalist' class structure
Irreversible wages ('stickiness' of wages)	Reversible wages
Technical change leads to higher wages for the producer ('Fordist wage regime')	Technical change tends to lower price for the consumer
Creates large synergies (linkages, clusters)	Creates few synergies

Source: Reinert (2007)

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[18] See Reinert, Erik S. 'Mechanisms of Financial Crises in Growth and Collapse: Hammurabi, Schumpeter, Perez, and Minsky', *Malaysian Journal of Economics (Jurnal Ekonomi Malaysia),* forthcoming 2012. WP version http://tg.deca.ee/files/main//2012040412332727.pdf