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THE IDEAS THAT CONQUERED THE WORLD

PEACE, DEMOCRACY, AND FREE MARKETS IN THE TWENTY-FIRST CENTURY

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CHAPTER NINE

The Triumph of the Market

IN MEDIEVAL Europe alchemists searched for a formula to turn base metals into gold. In the modern era the formula was found. Alchemy is a metaphor for the industrial process, the process of transforming raw materials into products with a higher value. It is in fact superior to alchemy, which aimed, in the terms of modern economics, simply to create more purchasing power without producing more things to purchase.

The industrial revolution did create, and in remarkable profusion, more things for people to purchase[1] and in so doing became the most influential development in human history since the invention of agriculture ten thousand years earlier.

At the outset of the twentieth century, a little more than a hundred years after the industrial revolution began, the capacity to produce wealth through economic growth, once the subject of myths, had become an established fact of life. This set the stage for the twentieth-century competition to determine the most appropriate political framework for industrial economies, which pitted the centralized planned system of the Communist world against the decentralized free markets of the West.

Its outcome was decisive. By the last decades of the twentieth century, as the market economies of Western societies lifted their inhabitants to ever higher standards of living, the giant Communist economies of the Soviet Union and China had come to practice a kind of reverse alchemy: The raw materials they used to create products had a greater value on the world market than the manufactured

goods that were made out of them. Of all the legacies of the twentieth century, this sweeping triumph of the free market is the one most widely accepted, and therefore most important, for the world of the twenty-first century.

TWENTIETH-CENTURY ECONOMICS

In the first decade of the post-Cold War era the market reigned supreme. Most sovereign states were indifferent to common security, the liberal approach to international relations. Many were hypocritical about democracy, the liberal method of governance. Yet virtually all embraced the liberal formula for organizing economic activity. The market's commanding status derived in no small part from the outcome of the Cold War, which was, among other things, a contest of economic systems. Indeed, the pattern of the economic contest more closely resembled the two world wars of the twentieth century than did the Soviet-American military rivalry.

In military terms, the Cold War was a stalemate. Dangerous at the outset, by its end it had settled into a stable and almost comfortable standoff, like a chess match in which the two contestants agree to a draw. The collapse of Communism was not the result of military victory.

As in the two world wars, in the first phase of the economic competition, which spanned the middle third of the century, the illiberal forces were in the ascendant and the West was in retreat. The Communist economic system, in which all economic activity was planned and controlled by the government, seemed more dynamic and successful than the market system.[2] The Soviet Union, where the command system was first established, appeared to escape the effects of the Great Depression of the 1930s that paralyzed world capitalism. It generated the military resources that enabled the Soviet Union to withstand and repel a massive invasion by Nazi Germany in World War II, and both before the war and in the two decades thereafter it produced impressive economic growth.

In the middle third of the twentieth century it was the command system, not the market, that inspired admiration and imitation.

Where Communist parties monopolized political power, in Eastern Europe, China, Vietnam, and Cuba, they established replicas of the Soviet economy. Even where orthodox Communism did not take hold, some features of its economic system were adopted. In much of what was known as the Third World, governments owned and managed much of the economy. The state did not plan everything, but it did plan a great deal.

In the Cold War economic contest between East and West, as in the two world wars, the tide eventually turned. In the last three decades of the century Communist economic principles were in retreat. By the century's end they were as thoroughly defeated as Germany had been in 1918 and 1945. The command system was all but extinct.

On the Western side, moreover, the economic competition, unlike the military contest, was waged by a genuine coalition, just as the two world wars had been. While in Cold War military affairs Germany and Japan played largely passive roles, in the economic arena they made crucial and independent contributions to the Western triumph.

Theirs were the largest economies in the two regions where the economic contest was most important. Europe and East Asia were both part of the world's core, where wealth and power were clustered and from which cultural innovations emerged. In both regions the contest was directly joined. Each contained both market and command economies and sometimes they were installed in different parts of the same divided nation: East and West Germany, North and South Korea, China and Taiwan.[3] In every case market principles proved superior. Western Europe in the third quarter of the century and East Asia in the fourth recorded the most impressive sustained growth on the planet.

Germany and Japan both rose from the ruins of military defeat to make themselves among the most powerful economies in the world.[4] Both promoted economic development in their home regions by exporting capital to their poorer neighbors.[5] In Europe, Germany was a partner to its western neighbors, a founding member of the economic and political association that had become, by the outset of the twenty-first century, the fifteen-member European Union. In

Asia, however, Japan was less a partner than a model, as other East Asian countries adopted features of its economic system with impressive results. South Korea, Taiwan, Singapore, Hong Kong, and several countries in Southeast Asia followed Japan's lead in achieving high rates of growth. Their collective experience came to be known as the Asian economic miracle.[6]

It is important to recognize that the late-twentieth-century triumph of the market was not only an outcome of the Cold War but also the culmination of the economic history of the twentieth century, the major theme of which was the expansion and then the contraction of the role of the state in economic affairs.

THE RISE AND FALL OF STATE MANAGEMENT

FOR MOST of the twentieth century the role of the government in economic affairs expanded. In the last three decades the trend reversed itself and the state retreated from the major tasks of economic activity: investment, production, and distribution. At the start of the century, in the countries of the world's core, it had been widely accepted that the government had, at best, a very modest part to play in each of the three. Government intervention in economic affairs came to be thought a relic of the pre-industrial, undemocratic world of tradition, which had been in full retreat during the course of the nineteenth century and was swept away, in Europe, by World War I. But that war also overturned the consensus on the proper balance, in economic activity, between state and the market.

In World War I the governments of the warring countries assumed far more economic responsibility than ever before. They took control of industrial production, they directed the allocation of capital and labor, and they rationed a host of commodities, all in order to enhance their military efforts. For the first time, all of society's resources were mobilized for a particular purpose, and it was the state that mobilized them.[7] The war demonstrated what government intervention could accomplish, and in the half century between 1920 and 1970 the economic role of the state expanded—in some countries more than in others.

In the world's core—North America, Western Europe, and Japan—the market remained the principal economic mechanism but, breaking with the pattern of the years before World War I, the state's role grew. Investment remained largely but not exclusively the preserve of the private sector, but the government influenced the allocation of capital, notably in Japan. Most firms and factories were owned and managed privately but some came under the jurisdiction of the state, often transferred to government control by the process known as nationalization. As for distribution, core governments redirected an increasing percentage of the national output to those deemed needy and deserving, such as the elderly and the indigent, or to those with sufficient political power, or both. The Western state in the twentieth century became a combination vacuum cleaner and sprinkler system, taking in wealth through taxation and recirculating it through transfer payments.

In illiberal Soviet-style economies the state took responsibility for everything. Lenin had been impressed by the German war economy and made it the model for Communist economics.[8] Government planning determined investment. Production took place in farms and factories owned and managed by the state. Communist regimes nationalized industry and agriculture across the board.[9] Decisions about distribution were also the preserve of the party-run state. Whereas in the core, and in most of the rest of the world, prices and wages were largely determined by market forces, in Communist countries the authorities set them by administrative fiat.

In much of what was known during the Cold War as the Third World—in Latin America, the Middle East, and especially South Asia—a hybrid economic system developed. The government exercised more control over investment than in the core, although not the total control characteristic of command economies. A larger state-owned industrial sector was created, but, unlike in Communist systems, it operated alongside privately owned industrial enterprises. The government also assumed considerable responsibility for distribution.

In this third approach to economic management, the government's role was undertaken in support of a particular strategy of economic development, one heavily influenced by the Communist example. That strategy aimed at developing heavy industry, which,

for most of the twentieth century, was considered the hallmark of economic modernity and the route to national wealth as well as the basis of national military strength. This strategy was known as state-led industrialization. It also went by the name of import-substitution, which was one of its principal policies: The countries following it aimed to make their own steel rather than being obliged to import it. In pursuit of this strategy Third World governments adopted a practice anathema to economic liberalism but central to the economics of Communism: discouraging trade with, and investment from, the rest of the world.

From the Bolshevik consolidation of power in Russia to the end of the 1960s, the prevailing economic trend in the world's core, in the Communist bloc, and in the Third World was not a liberal one. Some students of economic and political affairs predicted that, over the long run, the economic practices of Communism and the West would converge, with the economic role of the state everywhere becoming increasingly expansive and intrusive.[10]

At the end of the century a different type of convergence had become a reality. The world's economies were more alike in their institutions, practices and policies than at any time since World War I, but the economic model on which they were converging was not the one toward which they had seemed to be moving during the century's middle decades. In the century's last three decades, each of the three economic types encountered problems to which the market came to seem the only solution.

In the 1970s the core countries experienced, simultaneously, rapid rises in prices and dismaying declines in their rates of economic growth. In response to this distressing combination, which came to be known as "stagflation," market-oriented governments came to power in Great Britain in 1979, the United States in 1981, and Germany in 1982. Led by Margaret Thatcher, Ronald Reagan, and Helmut Kohl respectively, each country took steps to reduce the economic role of the state. Reagan and Thatcher practiced privatization, selling state-owned enterprises to private investors and managers, and deregulation, subjecting the previously regulated economic activities to market rules.[11]

The reversal of the trend toward greater government control over

the economy occurred even where self-styled conservatives did not hold sway. In 1981 Francois Mitterrand became the president of France and formed that country's first socialist government in twenty-five years, which proceeded to implement economic policies that French socialists had always favored: nationalization, increased government spending, and more regulation. The result was a currency crisis. Capital fled the country and the value of the French franc fell sharply. In response, Mitterrand executed an economic reversal, putting in place policies that resembled the ones being carried out in northern Europe and North America. Of the various episodes of economic liberalization in the core, the French case was perhaps the most telling. Thatcher, Reagan, and Kohl carried out policies in which they believed. Mitterrand, by contrast, found himself sponsoring the kind of economic policies that his party had opposed. The British, American, and German leaders were liberalizers by conviction. Mitterrand's socialist government embraced the market because there was no alternative.[12]

The economic pathology that led to a reversal of course in the import-substituting Third World was a crisis of debt. In the early 1980s a number of Latin American countries could no longer pay the interest charges on the loans they had received from major Western banks. They applied for relief. The banks, Western governments, and international financial institutions insisted that, in order to receive it, these countries adopt liberal economic measures: selling off state-owned assets, reducing government oversight and direction of economic activity, and opening their countries to goods and capital from abroad.[13] Although this meant repudiating the principles on which they had based their economic policies, the debtors agreed.

A decade later India found itself in comparable circumstances. It was by far the largest of the import-substituting countries and perhaps the most committed of any of them to that particular economic strategy. In the four decades after independence India had built a large state-owned industrial sector and had entangled its economy in a maze of regulations so intricate that a government permit was required for activities ranging from hiring and firing employees to opening and relocating factories to importing virtually anything

from abroad. So pervasive were these regulations that, while the imperial government of the first half of the century had been called the British raj, its successor came to be known as the "license raj."[14]

In June 1991, the Indian government found itself in a balance-of-payments crisis, with enough hard currency on hand for only two weeks of imports. It applied to the International Monetary Fund for a loan, which came with conditions similar to those the Latin American debtors had been obliged to accept a decade earlier.[15] India agreed in principle to open its economy, to cut back on its regulations, and to pare its state-owned industrial sector.[16]

The end of the third distinctive approach to economic management, the Communist command economy, took place in two stages. In 1978 China began a program of economic reform that led in short order to private property in agriculture, a quasi-private industrial sector alongside the state-owned enterprises created in the Maoist era, prices set by the market, and trade with and investment from the rest of the world.[17] By the 1990s the Chinese government had abandoned even a rhetorical commitment to a planned economy.

China underwent gradual economic reform. A decade later the Communist countries of Eurasia experienced sudden political collapse. The end of Communist rule left in its wake twenty-seven post-Communist countries stretching from the eastern border of Germany to the western border of China. In the first post-Cold War decade, in order to make the transition from central planning to free markets, all committed themselves to a more ambitious and difficult version of the package of measures pressed upon the import-substituting debtor countries of the Third World. The measures involved freeing prices from government control, shifting ownership from the state to private hands, and building the institutions that a functioning market economy requires.[18] By the beginning of the twenty-first century, success in making these changes varied widely among the twenty-seven, but all had embarked, at least tentatively, on the transition. None had tried to retain the Communist economic system.*

*The economic problems of the core countries in the 1970s, and of the Third World debtors in the 1980s, were bound up with the price of energy. The two oil shocks of 1974 and 1979, the first associated with the Arab-Israeli War of October 1973, the second with

The final chapter in the late-twentieth-century retreat of the state was triggered by the Asian financial crisis of the late 1990s, which affected the Third World countries that had, in the last three decades of the century, enjoyed the greatest economic success. The economic strategy of the East Asian countries differed from the one pursued in Latin America, the Middle East, and South Asia. It was more liberal. It relied for growth on exports rather than producing for a protected home market. This exposed the East Asian countries to the essence of market economics, vigorous competition, especially in the United States, which bought more of their products than any other country. Although the East Asians eschewed many of the illiberal economic practices of other Third World countries, they did embrace two of them. Their governments played major roles in channeling investment, through the control of foreign exchange and influence on large banks that served as the main conduits for capital. And although they depended on access to the markets of other countries, the East Asian countries did not reciprocate by opening their own to imports. When their currencies plunged, they, too, sought loans. As with Latin America and India, the loans came with conditions. Those conditions were familiar, involving a commitment to reducing the role of the state in economic activities.

What took place in the last three decades of the twentieth century is clear: The economic role of the state, having expanded for the preceding half century, began to contract the world over. How this happened is also clear enough: In the world's liberal core, in the partly

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the Iranian revolution of 1979, imposed the equivalent of a tax on the West and contributed to economic sluggishness. These same price increases drove Third World countries to borrow heavily to maintain the inflow of oil on which their economies depended. But when the core countries, especially the United States, went into recession in the late 1970s and early 1980s—a slump caused by the rise in interest rates designed to eradicate the inflation that the oil shocks had triggered when governments printed money to replace the purchasing power the surge in oil prices had removed—the debtors were not able to export to the markets in sufficient volume to earn the hard currency needed to service their debts.

The oil shocks also affected the Communist economies. The price increases gave Russia, an oil exporter, an economic windfall, which postponed, or at least disguised, its economic difficulties. The price spikes prompted both conservation in the consuming countries and the discovery of new sources of supply, which led to a decline in the price of oil in the 1980s. This penalized the Soviet Union and its clients by reducing their major source of hard currency.

liberal Third World, and in the entirely illiberal Communist countries economic problems, or crises, arose to which the solution was economic liberalization.

But *why* did this happen? Why did the state shift from hero to villain, from the key to economic growth to an obstacle to it? Why, in particular, did the most extreme version of government management, the Communist command economy, which had seemed, for much of the twentieth century, one of history's great successes, fail so emphatically that by the end of the century it had been entirely abandoned? Its failure can be understood by putting the economic history of the final decades of the twentieth century into the broader context in which it belongs, the two centuries of the modern era, which also happens to cover most of the history of the industrial revolution.

ECONOMIC GROWTH AND POLITICAL LEGITIMACY

THE DEFINING FEATURE of the industrial revolution is economic growth. Beginning in the last decades of the eighteenth century and continuing to the beginning of the twenty-first, it yielded a steadily expanding volume of products for human use. Growth has three sources: increases in capital from investment; increases in labor through population increase, immigration, or the inclusion of a greater proportion of the society in the workforce; and increases in the output that a particular amount of inputs—capital and labor—can produce, an increase in what is known as productivity. At different points in the industrial revolution the way that these three ingredients have combined has varied.

The initial stage was made possible by the invention of the first significant machines driven by inanimate power: the steam engine, the spinning jenny, the early techniques for mining coal and smelting iron. Once these were available two developments enabled Great Britain, the pioneer in the industrial revolution, and then other Western countries, to take advantage of them. One was the accumulation of capital. Britain had, in the eighteenth and nineteenth cen-

turies, the most sophisticated and powerful financial system in the world. The other was the movement of people in large numbers from the village to the city and from farms to factories, where they could operate the new machines. This counted as an increase in productivity as labor was transferred from a less to a more productive economic sector.

The first phase of the industrial revolution made traditional society obsolete because it was incompatible with the basic requirements of an industrial economy. Among these requirements was the commercialization of agriculture. Land had to be treated as a commodity that could be bought and sold in order to produce enough food to feed a growing urban population and to make some rural labor redundant so that people would move to the cities to work in the new factories. Traditional societies varied widely across the globe but everywhere they were based on the land and nowhere was land simply a commodity. It was, instead, the basis of a complicated network of obligations and privileges, a social structure binding owner to field worker, lord to peasant. It was these traditional institutions, these social worlds, that the industrial revolution threatened and that it ultimately swept away.[19]

Unlike the world of tradition, for this first phase the Communist system proved adequate. Indeed, for a time it seemed optimal.[20] The command economy could not have produced the machines on which the first stage of the industrial revolution depended.[21] Once they had been invented, however, and the initial pattern of industrialization established, the command system proved serviceable. The enormous power of the state gave the government the means to squeeze savings out of the agrarian sector and to direct it to industry on a large scale. Communist countries typically had higher rates of investment than countries with market economies,[22] and the governments of Third World countries attempting state-led industrialization also devoted themselves to mobilizing and directing investment. Communist governments could also compel rural laborers to move to cities and work in factories.

In fact, the Communist command system, first developed by the Soviet Union in the 1920s, was simply the most extreme version of a common pattern of industrialization in which the later the industrial

revolution came to a country, the more extensive the role of the government in promoting it was likely to be, above all in mobilizing capital for investment.[23] To be sure, the guiding hand of the state was not necessarily superior to the invisible hand of the market in promoting the initial stage of the industrial revolution. In retrospect, it is not clear that Russian economic growth even accelerated under the system the Bolsheviks put in place. Imperial Russia had set out on a more conventional path of industrialization (although one in which the Russian government played an important role) before World War I. Had it continued on that path it might have grown just as rapidly and more efficiently, and the price of growth paid in blood by the Russian and the other peoples of the Soviet Union would certainly have been much lower.[24]

But if not necessarily superior to the market, the command system did work. The Soviet Union, the countries of Eastern Europe in which the USSR installed ideologically similar governments after World War II, and China after 1949 did acquire industrial economies under Communist auspices. People migrated in large numbers from the countryside to the cities. Governments built, owned, and managed huge industrial complexes.

Third World countries committed to state-led industrialization also achieved economic advances, particularly in heavy industry. The average annual rate of economic growth in India after independence was 3.5 percent. This was hardly spectacular, and because the Indian population also increased, per capita growth was low.[25] But that rate was an improvement on the estimated rate of 1.3 percent for the period of formal British rule from the mid-nineteenth to the mid-twentieth century.

The major products of the initial stage of the industrial revolution were capital goods, which were themselves used for production rather than sold to individual consumers. As Karl Marx and Friedrich Engels observed in *The Communist Manifesto*, written in 1848, the bourgeoisie, as the promoter and beneficiary of industrialism,

> has created more massive and more colossal productive forces than have all preceding generations together. Subjection of nature's forces to man, machinery, application of chemistry to

> industry and agriculture, steam navigation, railways, electric telegraphs, clearing of whole continents for cultivation, canalization of Rivers, whole populations conjured out of the ground.[26]

These were enormous and momentous changes, but they differed from the changes in social life brought about by the next stage of industrial revolution. These subsequent changes were in what was produced, and above all in what people could own and use themselves. The next stage brought to human life something that Marx and Engels did not live to see: the age of mass consumption. For the first time people in large numbers gained access to what once had been either luxuries reserved for the very few or unavailable to anyone because they did not exist.[27] The great beneficiaries of this stage of economic advance were members of the general population. It was they who were the main purchasers of goods produced on a mass scale. They had to be: There were not enough people of great wealth to buy them.

In 1964 the sociologist David Riesman published a collection of essays on American life entitled *Abundance for What?*[28] The title would have been unthinkable at any other time and in any other place. An abundance of material goods had never existed in any society anywhere prior to the twentieth century. But by the middle of that century in the wealthiest country of the Western core, and in the ensuing decades in other core countries, abundance had become a fact of everyday life. Mass consumption was indispensable for economic growth in the twentieth century as it had not been in the nineteenth, and the failure to sustain it was at the heart of the Great Depression of the 1930s.

As important as it was in economic terms, in the twentieth century mass consumption turned out to be just as significant politically. It was something in which everyone, everywhere, wished to participate. Marx had called religion the "opiate of the masses." Its mysterious allure had, he lamented, bewitched the people of the capitalist countries and so diverted them from the militant pursuit of their true interest—the overthrow of capitalism. In the twentieth century the opiate of the masses was consumer products, the failure to make adequate provision for which subverted the political systems that

had been established in Marx's name.* The term economists used for what people consumed, "goods and services," was revealing. Goods implied things universally acknowledged to be positive and desirable. Services are what were available, before the twentieth century, only to those wealthy or privileged enough to employ servants. In the twentieth century goods and services were what people the world over wanted, were determined to get, and increasingly demanded that their governments help them acquire.

Mass consumption was another innovation of the Western core. Here the pioneer was the United States and it was a significant American contribution to human civilization. Like other innovations, once it was made and it was clear that it could be made, the demonstration effect of mass consumption turned out to be powerful. With travel and communication possible on an ever-widening scale in the twentieth century, more and more people could see that abundance was available; once they saw it they wanted it for themselves.[29]

This development had political consequences. In the Western core, national elections often turned on economic conditions. Growth favored the incumbents, its absence gave the advantage to challengers.[30] While the core had entered the age of mass consumption,[31] many of the countries of the world's periphery had not, which endowed with even greater significance the capacity to nurture and sustain an economy that could provide consumer goods on an appreciable scale. That capacity became a test of the worthiness not of a particular political party but of the political system itself. The Chinese economic reforms testified to this. The Communist Party gave up most of its ideological pretension and much of its control over Chinese society in order to foster the economic advances on which, it came to believe, depended its chances of remaining in power at all,

*The parallel could be taken further. In traditional society the most familiar images, the ones that dominated the man-made landscape, were religious: churches, icons, works of art depicting Biblical scenes. In consumer society what were visually ubiquitous were images of, and thus both reminders of and tributes to, consumer products—that is, advertising. The singer John Lennon once caused offense by asserting that his group, the Beatles, was "more popular than Jesus." The statement was dubious even at the time it was made, but the image of, say, a bottle of Coca-Cola was certainly as familiar in the second half of the twentieth century as the depiction of Christianity's central figure.

even in a role much diminished from what it had been at the Maoist zenith.[32]

For most of the modern age the test of political legitimacy was the capacity to protect sovereign borders. By the end of the twentieth century another test had equal, if not greater, importance: the capacity to "deliver the goods." This was a test on which the state-led industrializers of the periphery did badly and on which the command economic systems of the Communist world did even worse. The evidence of Communism's failure had a profound effect on Russia's first post-Communist president, Boris Yeltsin.

> A turning point in Yeltsin's intellectual development occurred during his first visit to the United States in September 1989, more specifically his first visit to an American supermarket, in Houston, Texas. The sight of aisle after aisle of shelves neatly stacked with every conceivable type of foodstuff and household item, each in a dozen varieties, both amazed and depressed him. For Yeltsin, like many other first-time Russian visitors to America, this was infinitely more impressive than tourist attractions like the Statue of Liberty and the Lincoln Memorial. It was impressive precisely because of its ordinariness . . . On the plane traveling from Houston to Miami, Yeltsin seemed lost in his thoughts for a long time. He clutched his head in his hands. Eventually he broke his silence. "They had to fool the people" [he said.] "It is now clear why they made it so difficult for the average Soviet citizen to go abroad. They were afraid that people's eyes would open."[33]

Even in the Soviet Union before the Gorbachev era, a country entirely without political freedom, the rulers felt the need to make some concessions to the wishes of those they ruled. In the latter stages of its existence there was an unofficial, tacit "social contract" between the two, in which the populace gave up any claim to political participation in exchange for a steadily rising standard of living. But the Communist system did not maintain its side of the bargain. In its early years the command system was a mechanism for catching up with the advanced industrial economies of the core; at the end it

had become a way of falling further behind. The reason that it did not pass the test of delivering the goods was that it could not do so. It was, unintentionally, designed to fail.

Passing the test required shifting from one pattern of economic advance, extensive growth, to another, intensive growth. The first approach increased output by increasing inputs, the second by making more efficient use of existing inputs. The first growth pattern is investment-led, the second driven by advances in productivity. Advances in productivity were an important part of the first phase of the industrial revolution, but they were achieved in no small part by transferring labor from the agrarian to the industrial sector. In the next stage, which was also the stage of production for mass consumption, with surplus labor no longer available, improvements in productivity had to take place *within* sectors, by the more effective use of a steady stream of resources. This the command economy proved unable to do: The kind of productivity upon which growth in the twentieth century depended was beyond its capacity to deliver.

Productivity in the twentieth century core economies was something of surpassing importance—growth depended on it—but also curious and even mysterious.[34] Economists could track and measure it but they did not know how to generate it.[35] But if the precise way to engender improvements in productivity was not known, the circumstances in which improvements were likely to occur, the features of an economic system conducive to them, were evident. And these happened to be features integral to market economies and impermissible in command systems.

Competition among firms is important for productivity. It puts pressure on each enterprise to make better, less expensive products lest its rivals do so and thus drive it out of business. Command economies did away with competition and outlawed the standard by which market competition is waged—profitability.[36] Firms must be autonomous so that they are free to experiment with different ways of doing things, which is how better ways are discovered. In the Communist system firms were completely controlled by government planners and in many of the Cold War economies of the periphery—India's, for example—they were tightly circumscribed by government regulations. But to promote advances in productivity

private ownership is indispensable because it gives owners a powerful incentive to find ways to increase profits: The profits accrue to them. In state-owned enterprises none of the personnel stood to benefit from a better performance and none stood to sustain a comparable loss—of personal assets—from a bad one.[37]

The market system can enlist one of the most powerful of human motivations, the pursuit of self-interest, in the quest for economic growth. On this score the less liberal economies of the periphery were less successful, and the command economies of the Communist world entirely unsuccessful. The institutions and practices necessary for economic growth in the latter part of the twentieth century were not only missing from the planned economies, they were also antithetical to the economic and political principles that these systems embodied.

Just as the traditional social, economic, and political order was incompatible with the initial needs of the industrial revolution, so at the end of the twentieth century the Communist economic system proved incompatible with the requirements of the next stage. It, too, was consequently rejected and discarded. Marx was stood on his head. He had asserted that capitalism was a transitional stage between traditional society and Communism. Instead, Communism proved to be a way station between the peasant societies in which it took power and the mass-consumption society that only the liberal approach to economic management could provide. In the vocabulary of natural evolution, the market system proved to be adaptive, while the command system (and its less rigorously controlled imitators) failed to meet the acid test of adaptation, the equivalent of evolution's capacity for reproduction—the provision of consumer abundance.

Yet the traditional and Communist orders that the market eclipsed have had a kind of posthumous revenge.

OPPOSITION TO THE MARKET

FOR ALL THE wonders that it produced, the free market has had a consistently unsavory reputation. The human qualities necessary

for the successful operation of the market have seldom been highly valued, least of all in the ways that artists have depicted Western society.[38]

In feudal Europe, in the caste system of India, and in imperial China, merchants never stood at the top of the social hierarchy. In modern times the calculation, the compromise, and the determined pursuit of self-interest that fuel the system that created abundance have more often been denigrated than exalted. Selflessness is a term of approbation; selfishness is not. Yet the market system, which is explicitly based on selfishness, did more for those living in societies where it operated than did the system of planning, which was, ostensibly, the expression of selflessness.[39] Philanthropists earn praise for giving away their money, not for making it.[40]

Modern literature has not been kind to men whose working lives were spent in the marketplace. Balzac's bankers and proprietors are not admirable characters, and perhaps the best-known fictional American businessman of the first part of the twentieth century, Sinclair Lewis's Babbitt, is not an advertisement for the life of commerce.

One notable twentieth-century contribution to the understanding of the dynamics of economic growth did define an heroic role arising from the modern market. In attempting to explain how the innovations that make economic growth possible come to pass, the economist Joseph Schumpeter assigned a crucial part to the individual he called the entrepreneur, the person who launches a new way of doing things. The entrepreneur is an heroic leader who, against the odds, without the guidance of precedent, and at risk to his fortune creates an enterprise that is new, vital, and profitable.[41]

The entrepreneur, and the executive who directs the enterprise the entrepreneur has established, found an admiring constituency in the twentieth century in the United States. A conspicuous vehicle for celebrating their virtues was the nation's largest general interest weekly magazine, *Time*. Especially during the boom decades of the 1920s, 1950s, and 1990s, captains of industry regularly graced the magazine's cover, which functioned as a kind of nationwide billboard and gave the person so depicted, for a week, the kind of public visibility usually available only to figures from politics, entertainment, and sports.[42] But even in the United States, the market and the

people who worked in it were not universally admired. In the vivid cinematic depiction of the heart of the American financial system, Oliver Stone's *Wall Street*, the central figure, Gordon Gekko, takes his name from a lizard and displays a reptilian character as well.

The mixed reputation that commerce and industry enjoyed in the Western core even as they were producing riches previously undreamed of was hardly a fatal hindrance to recruiting people into their ranks.[43] But beginning in the nineteenth century the market was subjected to criticisms beyond its alleged complicity in fostering undesirable patterns of conduct, and these had deeper political consequences.

One such criticism was that the market was not, and could not be, the most effective way of organizing economic activity. The market was deemed contrary to the spirit of the modern age and to the central precept of the European Enlightenment that helped pave the way for it: the power of the human intellect to comprehend and manage the world. In this sense, Communist central planning, the application of human reason to one of society's most important tasks, was the quintessential Enlightenment project. Economic planning by the government seemed, on its face, a more promising approach to economic management than depending for food, clothing, and shelter on the haphazard, uncoordinated, and apparently random workings of the free market.

In fact, the market does not work haphazardly. Like central planning it is a system of coordination, but one that operates through the decentralized pursuit of self-interest on the basis of impersonal rules rather than by hierarchically administered commands given by government officials.[44] It is a liberal system of coordination, based on individual desires and voluntary transactions in the context of universal rules rather than an illiberal one in which the few exercise arbitrary power over the many. Adam Smith called it "a system of natural liberty"[45] and it turned out to be effective in promoting economic growth. In economies as complex as those of the twenty-first century, an enormous amount of information must be transmitted, processed, and acted upon; this is far more effectively accomplished in a decentralized than in a centralized manner.[46]

A more telling criticism of the market indicted it for dizzying and

economically painful oscillations between boom and bust. This criticism was well-founded. From the early decades of the nineteenth century the economies of the core were prone to slumps, in which decreases in production destroyed businesses and deprived people of their jobs. The worst of them, in the 1930s, was so severe that it shook faith in the market throughout the West. Central planning won converts because it seemed able to avoid such downturns.

It was the achievement of John Maynard Keynes, the most influential economist of the twentieth century, to discover how to moderate, if not abolish, Western capitalism's downward swings. Before Keynes, the market was understood as a self-regulating mechanism, with downturns that could not be prevented but that would ultimately correct themselves. Keynes had a different vision. He saw the market economy as a machine powered by the battery of consumer spending. Occasionally the battery would run down, causing the machine to falter; this was what had happened in the 1930s. The machine could be restarted by recharging the battery, which spending by the government could accomplish.[47] With Keynes the profession of economics came into its own. By the end of the twentieth century it had become the priesthood of economic life, its authority recognized, its advice sought, its members fully integrated into the governance of modern states.

Like the industrial revolution itself, and like the liberal approach to international relations, common security, and the liberal approach to political order, democracy, the study of the liberal method of economic organization—the market—had its origins in the Anglo-American world. The founder of modern economics was a leading figure of the eighteenth-century Scottish Enlightenment, Adam Smith. It was he who, in *The Wealth of Nations*, published in 1776, first described in detail the workings of the market. Most of his prominent successors, Keynes foremost among them, were either British or American by birth, training, or residence—or all three.[48] All of neoclassical (that is, non-Marxist) economics is descended from Adam Smith in the sense that all neoclassical economists have taken the market as their subject and virtually all have believed in its virtues as a way of coordinating economic activity.[49]

In the twentieth century economics came to resemble another

field of inquiry and practice for which a Nobel Prize was awarded: medicine. Both were applied sciences devoted to the enhancement of human welfare. Both proceeded by experimentation through trial and error. Both were far more sophisticated at the end of the century than at the beginning. Economists, like medical practitioners, knew more, and knew what they knew with greater precision. Both relied on exact measurement. Greater knowledge made both more useful. People were richer and lived longer in 2000 than in 1900, in no small part because of advances in economics and medicine.[50]

The findings of both medical science and economics, moreover, are universally applicable. No two human bodies are exactly alike, of course, and the treatment of the same disease will vary from case to case, but some basic medical principles are true for everyone. Similarly, while national economies differ widely in important ways, some economic principles are relevant to them all. Perhaps the most important of these are the principles of growth. There was, at the end of the twentieth century, a consensus among economists on what is required for economic growth everywhere: a liberal, market-enhancing state that protects property rights and encourages investment; freedom for firms to enter and compete in markets; openness to trade with and investment from the rest of the world; sound monetary and fiscal policies with modest deficits and low inflation; and measures to enhance the health and levels of education of the population.

This meant that the rapid growth of the East Asian economies in the last three decades of the twentieth century was not the result of a singular local form of political management but rather of diligent attention to the fundamentals, especially investment financed by high rates of saving.[51] It also meant that Africa was not poor for any uniquely African reason but because the countries of the region had not put in place the institutions and practices that would lift them out of poverty. Poor countries had no need to invent the machines and technologies of industrial production, which were well known and widely available. They had simply to create the conditions in which these could be effectively utilized.[52]

It was not, however, a magic formula, one that every country could easily adopt. If it had been, the gap between the richest and the poorest countries would have narrowed steadily in the years follow-

ing the end of the Cold War, with the least wealthy following, smoothly and rapidly, the path that the leaders, with far greater effort, had blazed. Instead, the gap grew wider because the two hundred-odd sovereign states of the international system varied greatly in their capacities to put in place the conditions for economic growth.[53] The failure to do so, in Africa and elsewhere, had its roots in local history, culture, and politics, and here economics resembled not so much medicine as public health.

Eradicating cancer, for which no cure was known at the outset of the twenty-first century, depended on advances at the frontiers of medical science. Eradicating cholera, by contrast, for which a vaccine was available but outbreaks of which still occurred in poor countries, was a problem of public health. What was missing in the case of cholera was not the scientific understanding of the disease but rather the administrative and ultimately the political capacity to put into practice the measures that followed from scientific understanding.

To extend the average life expectancy in rich countries, to take another example, from seventy-five to one hundred years is a scientific problem; to extend it from fifty to seventy-five in poor countries is a political one. Similarly, to raise the long-term rate of economic growth in the United States, which has the world's most advanced economy, is a problem in economic research; it requires a breakthrough in the understanding of the nature of productivity. Slow growth in poor countries is a political problem, requiring for its solution the political capacity and the political will to create the conditions known to make economic advancement possible.

At the outset of the twenty-first century, economists did not believe that the market, remarkable instrument for the generation of material abundance though it was, could perform all the functions that an economy requires. To the contrary, one of the major subjects of economic research was how and why markets fail. It is market failure, when the pursuit of individual interest does not lead to optimal outcomes, that creates the need for public goods. An important part of the study of economics is deciding what markets can and cannot do and how best to compensate for their deficiencies. In the modern age the ongoing challenge to the market system, however, and one that prompted basic alterations in the nineteenth century model of

industrial capitalism, came not from the market's failures but from its successes. Historically, the chief threat to the political viability of the liberal economic system was not what it could *not* do, but rather what it did well.

THE PROBLEMS OF SUCCESS

THE WORKINGS of the market when harnessed to the industrial revolution disrupted the long-established routines of millions of people. The market produced spiritual and physical impairment on a scale that before the modern age even wars seldom did. Marx and Engels were especially eloquent on the psychological dislocation:

> The bourgeoisie . . . has put an end to all feudal, patriarchal, idyllic relations. It has pitilessly torn asunder the motley feudal ties that bound man to his "natural superiors," and has left remaining no other nexus between man and man than naked self-interest, than callous "cash payment." It has drowned the most heavenly ecstasies of religious fervor, of chivalrous enthusiasm, of philistine sentimentalism, in the icy water of egotistical calculation. It has resolved personal worth into exchange value, and in place of the numberless indefeasible chartered freedoms, has set up that single, unconscionable freedom—free trade.[54]

In traditional society, people led the same lives, in the same places, as had their parents and grandparents. In the modern society the industrial revolution made, the world was new for every generation. This created unprecedented opportunities for betterment, to be sure, but it also produced many unfamiliar pitfalls. In traditional society life was a process of repetition, in modern society one of adaptation. A migrant from the traditional countryside to the modern city moved from security to insecurity, which made for disorientation and discomfort. It was not accidental that one of the medical innovations of the modern age, which was born at the end of the nineteenth century and grew rapidly in the twentieth, was psychiatry, and that one of the widespread ills it addressed was anxiety.

Industrial life took a physical toll as well. Crowded into unsanitary

dwellings, toiling in unsafe mines and factories, workers were prey to diseases and accidents that their peasant forbears had never had to encounter. Nineteenth century urban poverty was not necessarily worse than the life of chronic shortages and occasional epidemics of traditional rural society but it was more visible and painful because it festered within sight and within reach of the rising affluence that economic growth produced. In traditional society poverty was the natural, unavoidable lot of the vast majority. In modern society everyone came to aspire to, and ultimately to expect, something better. The costs of modern urban life were noticed, and captured, in literature. The industrial revolution inspired the nineteenth century novel of realism, with its (sometimes) implicit theme of social protest, as practiced by writers such as Charles Dickens in England, Theodore Dreiser in the United States, and Emile Zola in France. On the whole, the combination of the market and the industrial revolution increased human welfare; neither would have been sustained over two centuries otherwise. But the advance in welfare came at a price. And this had to be so.

Schumpeter called economic growth a process of "creative destruction."[55] By its nature it both created and destroyed: indeed, it created *by* destroying. Economic growth depends chiefly on increases in productivity. Productivity involves doing things differently: making new things, or old things in a new way, or the same things in the same way but by different people in new places. The essence of productivity is change and change is usually disorienting and often painful. It requires adaptation and penalizes those who cannot adapt.

The mechanism by which the market produces growth is expressed in a story some version of which is a standard feature of introductory economics. If steel can be made more cheaply elsewhere, under free-market conditions local steelworkers will lose their jobs. Labor and capital will thereby be released so that they can be redeployed to a more efficient and thus more profitable use. In theory, the newly unemployed steelworker puts down his tools, changes from his heavy work clothes to a more comfortable outfit, walks across the street to a newly constructed office building and takes one of the jobs available there as a computer programmer. The

story is, at some level, true, and it has a happy ending. Under the pressure of the market, steel industries do shrink and computer-programming firms do expand, making both steel and computer programs less costly to consumers everywhere. Society is better off. Consumers are winners.

But within this happy story there is an unhappy subplot. Unemployed steelworkers are losers. Few if any will be reemployed as computer programmers, many will have to take jobs paying less than the ones they have lost, and some will find no new job at all. In rural, traditional society virtually every person made some contribution to scraping a living from the soil. Unemployment is an artifact of the modern age. So, too, is poverty among the elderly. In rural, traditional society few people lived longer than they were able to work and their families cared for those who did. The combination of medical advances leading to longer life and the strain of industrial labor produced, in the twentieth century, a growing number of people unable to continue to support themselves but lacking the dense family networks that would have supported them in the traditional countryside.

Not surprisingly, the social costs of the industrial revolution gave rise to the impulse to prevent, cope with, and compensate for them, which, in the second half of the nineteenth century, took a political form. The name commonly given to the political movement with these goals is socialism.[56] In the twentieth century socialism split into two camps. The Marxist-Leninist wing took power in the former tsarist empire, created the international Communist movement that gained control of Central Europe, and carried the banner of illiberalism in the contest with the liberal West in the second half of the twentieth century.

In the Western core the socialist movements generally accepted as axiomatic political democracy and the economic primacy of the market. They sought, by democratic means, to moderate the market's destructive effects. European social democrats were attracted, for much of the twentieth century, to an expanded role for the government in investment, through planning, and in production, through state ownership. This enthusiasm died away in the last decades of the century. But the social democrats' principal interest, which they

shared with similar political forces in North America, was to enhance the role of the state in the distribution of what society produced in a way that mitigated the harsh consequences of industrial civilization. Here the Western branch of the socialist movement succeeded. It created the welfare state.

Political pressure encouraged the creation of the welfare state. The forces demanding government-supplied padding for the shocks of the industrial revolution grew in strength from the middle of the nineteenth century to the middle of the twentieth, overcoming the resistance of the partisans of strict laissez-faire. As its advocates grew in strength (and its beneficiaries grew in number), the welfare state expanded in scope, from old-age pensions to unemployment insurance to health care. Within each category throughout the Western core, the scope of the services on which each citizen could count, and the sums the government spent on them, also grew steadily, as, in consequence, did the level of taxation needed to pay for them.

The welfare state came into being and expanded not only because its proponents were increasingly powerful, but also because of the growing legitimacy of the idea that society owed its members some form of social protection. Behind the idea lay three related arguments. One was that the victims of the industrial revolution deserved support. They were the casualties of a struggle that brought wide benefits to the society that waged it. Economic progress was like a war that had been worth waging and had ended successfully but that had also produced wounded people who were therefore owed compensation for their sacrifices.[57]

Another was that compensation for the risks of the industrial revolution was necessary to induce people to take part in it in the first place. The welfare state provided a "social safety net," a term suggesting that participation in the modern economy resembles walking across a high wire: No reasonable person would attempt it, and no one would have the confidence to do it successfully, without knowing that society was supplying something to break a possible fall. A third motive for yielding to the demands for social welfare was fear: Without some protection from the costs of the market system, those who benefited from it had reason to worry, its victims and potential victims would rise up and overthrow it. The ambitions and, after

1917, the achievements of the revolutionary wing of socialism served as a powerful incentive for the propertied classes to accede to the demands of its social democratic wing. This was a way of buying the internal peace and stability without which free markets cannot function, and it was not coincidental that a large upsurge in social spending in the West occurred in the years following 1945. From the onset of the Great Depression to the end of World War II all the countries of the Western core were riven by social conflict, which was aggravated, if not always created, by economic stress. In many cases the conflict approached, and in some cases it crossed, the threshold of civil war.

The growth of the welfare state substantially modified the nineteenth-century model of economic liberalism. In the early decades of the industrial revolution the liberal orthodoxy held that the proper economic role of the government was a minimal one. The ideal was the "night-watchman state," with the government standing guard at the factory gate to prevent theft but keeping resolutely clear of anything to do with the factory's operation. In the twentieth century, in the Western core, the state acquired an ever-larger role in redirecting the fruits of economic growth, a role that Adam Smith had never imagined and that the most powerful political forces of the nineteenth century had opposed.

The rise of the welfare state reconciled the two strands of political liberalism—popular participation and constitutionalism—which in the nineteenth century had seemed to be at odds with each other. It made popular sovereignty through universal suffrage compatible with the protection of private property by giving every citizen property in the form of an entitlement to benefits from the state. The liberal state of the twentieth century guaranteed the social protection of the poor just as it did the estates and businesses of the rich, thereby giving the first group as well as the second a stake in maintaining it.

For a hundred years, starting in the middle of the nineteenth century, one question at the heart of the politics of the liberal Western core was whether the state should compensate the public for the displacements and injuries caused by the industrial revolution. By the middle of the twentieth century the argument had been settled. For

the second half of the twentieth century the domestic politics of the countries of the core were concerned with how extensive government welfare benefits should be.[58]

Due to advances in medicine more people were living longer lives, thereby increasing the costs of the benefits promised to everyone after the age of retirement. Virtually every public benefit in every Western country was financed on a "pay-as-you-go" basis, meaning that they were financed out of current revenues rather than with existing savings. But in the first decades of the twenty-first century the ratio of the working-age populations that generated the revenues to the sector of the population eligible to receive them was destined to fall, the result of a reduction in fertility rates in all of these countries.[59]

Thus, while public life in the core in the second half of the twentieth century revolved around how far to raise and extend benefits, the politics of the first half of the twenty-first century seemed likely to have at their center the issue of how far and how fast to reduce benefits.[60] The politics of generosity are easier and more pleasant to conduct than the politics of restraint. It is better—in any event it is easier—to give than to take away. But even if the less agreeable of the two should dominate the political debates and elections of Western Europe, the United States, and Japan in the first half of the twenty-first century, this would still make for an easier set of tasks and choices than the ones that most of the countries of the world's periphery faced.