HISTORY OF GLOBAL ECONOMY

We begin our discussion of the history of the global economy with the following question: What has led to such strong differences across regions of the world? The quick and dirty answer is simply the "West" developed first.

Birth of Capitalism

One can find examples of sustained economic growth throughout history; the woolen industry in 13th century Flanders and in 14th century Florence is an example. Starting with the 11th century, long distance trade flourished, connecting thriving pockets of growth between Venice and the Netherlands. However, overall, living standards remained at subsistence levels for the majority of the world's population until the middle of the 18th century.

Over the centuries as commerce grew, albeit slowly, the power of the vassals of the feudal system declined and was replaced by merchants and incipient capitalists. Innovations in sailing led to long distance trading. The opportunities and challenges of sending a vessel abroad for years at a time brought about new institutions, which facilitated the growth of the modern capitalist system.

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At the same time, the feudal economy was further weakened by burgeoning industrialization and urbanization, changing both the political as well as the economic structure of Europe.

The question remains why in the “west”?

Some of the factors contributing to these changes were:

1) The Protestant Reformation - note the industrialization began in northern Europe. Protestant work ethic contained virtues such as hard work, frugality, sobriety and efficiency, which facilitated capitalism.
2) Rise of strong nation states - 16th through 19th century. The nation state created conditions conducive to capitalism. It provided domestic markets free of trade barriers, a uniform monetary system, contract and property laws, police and militia protection, as well as basic transportation and communications infrastructure. Initially, absolute monarchs wrested power from feudal lords and town authorities, consolidating the territory into nation states. Eventually, as the power of capitalists and the middle class, or bourgeoisie, rose, the monarchs ceded power to a more representative structure.

3) The Enlightenment - during the 17th and 18th century there were great scientific and social advances. Discoveries of oxygen, electricity, and calculus, among many other findings led to practical applications in agriculture and industry. This period laid the scientific foundation for the industrial revolution. Society stressed the rights and responsibilities of the individual, weakening the power of institutions such as the church and state, which had patronizing relationships with the masses. This liberal philosophy emphasizing freedom from arbitrary authority further led to the rise of the middle class and the overthrow of the landed gentry. It eventually led to political revolutions, not only in the United States but in England, Holland, and France as well.

The profits earned from international trade and the flow of gold and silver from the Americas financed the accumulation of capital, which furthered reinforced industrialization and capitalism.

Capitalism and Colonization

Capitalism as an economic system spread beyond Europe, mainly to North America and Australia. One may ask why capitalism and new technologies did not spread elsewhere. One possible answer is the indigenous peoples of North America and Australia were not particularly numerous as compared to other regions. New immigrant waves, primarily from Europe, and descendants of the English and French colonists cause the European population to swell, overwhelming the indigenous peoples who were (at
best) pushed aside. The European immigrants using their skills and technologies acquired from their home countries to embark on creating new industries in North America and Australia. In Africa, the Indian Subcontinent, East Asia, and Latin America, however, the indigenous peoples were relatively numerous. Being greatly outnumbered, the colonist created an administrative structure, which encouraged, or more likely coerced, the indigenous peoples to produce primary products for export to the home countries. These primary products were then transformed through the production process into manufactured goods, some of which were re-exported back to the colonies. Under these conditions there was little incentive to create new industries in these colonies.

Japan

Japan proved to be an exception. Until the Meiji Restoration (1868) Japan was basically a closed society. Feudal structures and a strong caste system were the main characteristics of this island nation. Being isolated and having an insular culture, which mistrusted foreigners, the Japanese were caught unaware of the economic and military power of the Western nations when Admiral Perry sailed into Yokohama harbor. The Japanese, understanding their great disadvantage, began a frantic and zealous campaign to industrialize in the latter part of the 19th century. Borrowing western technologies, the Japanese managed to build steel industries, create a modern navy and in1906 defeat the Russians in a naval battle in the Sea of Japan.

Britain’s Decline

The world economy during the 19th century was centered on Britain's early start in the industrial revolution. Current account surpluses led to the English Pound becoming the world’s major currency and the gold standard was established creating a system of fixed exchange rates. By the end of the century British foreign direct investment and the diffusion of technology spread industrial development to the European continent and North America leading to greater international competition. Britain did not respond to the new technological and managerial realities. Their dominance began to diminish. The advent of steel and chemical industries, which enjoy economies of scale, led to the creation of large corporations. The British maintained the status quo with small to medium size family manufacturing industries. The US, with its large and growing internal market, was better placed to exploit these new industries.
Twentieth Century

At the beginning of the 20th century the global economy was in turmoil. Financial crises were common. Policies to protect domestic industries, such as tariff measures, stifled trade. Political alliances in Europe divided the continent into two camps. The assassination of Archduke Ferdinand in the Balkans sparked the century’s First World War. The advent of technology in warfare had devastating effects; machine guns, armored tanks, and the use of poisonous gas brought warfare to a new level of barbarity, shocking the world. In its aftermath, President Woodrow Wilson advocated a new-world order centered on the League of Nations. While grand in concept, the political realities of the day made it ineffective. The cost of WWI to Britain resulted in the abandonment of the gold standard, a system of exchange rates backed by gold. The post WWI era was marked by a resurgence of economic prosperity, particularly in the United States. However Germany, saddled with reparations, payments to Allied powers (France in particular) for damages caused during the war, faced devastating hardship. The German currency suffered a hyperinflation making it near worthless. At the end of the 1920s, Germany began to get back up on its economic feet.

The US stock market crashed in 1929. Inappropriate policy responses led to the Great Depression and its repercussions spread to Europe as competitive policies of trade protection and currency devaluations were implemented in vain attempts to protect domestic economies. The US Congress passed the Tariff Act of 1930, better known as the Smoot-Hawley Tariff Act. This measure raised tariffs on imports to an average of 50%. This "beggar thy neighbor" policy led to a vicious cycle of reciprocal tariffs and other restraints to trade. International trade came to a halt in the mid-1930s deepening and lengthening the Great Depression both in the US and abroad.

Germany, resurfacing after a decade of deprivation, now faced a new economic challenge. Political turmoil ensued and the 1933 elections saw the rise of the National Socialist Party headed by Adolf Hitler. Embarking on a re-industrialization policy, the Nazis expanded their military capacity, built the famous German highway system, the Autobahn, and encouraged production of the people’s car, the Volkswagen. Flexing their new found military might Germany, under the Nazis, invaded Czechoslovakia in 1937 and precipitated World War II with the invasion of Poland in 1939.
Post-World War II

In 1944 it became clear the war was coming to an end, and the western Allied powers decided to again attempt building a new world order. Meeting at the Mount Washington Hotel in Bretton Woods, New Hampshire, the US and English representatives, H.D. White and J.M. Keynes respectively, (yes, Keynes of the Keynesian Macromodel!) set out to create institutions to prevent the reoccurrence of the conditions which led to WWII.

They proposed the creation of three organizations, with each organization playing a role in the smooth functioning of global economy. These were:

1) The International Bank for Reconstruction and Development (IBRD or more commonly the World Bank) whose original mandate was to rebuild the war torn economies of Europe and Asia. It has evolved into the world’s most influential lender of foreign aid to developing nations.

2) The International Monetary Fund (IMF) whose primary purpose was to maintain a fixed exchange rate system known as the Bretton Woods System. After the dissolution of the Bretton Woods System in the early 1970s the IMF has become the world’s overseer of the international financial system, recently playing a highly visible and controversial role in the aftermath of the East Asian financial crisis.

3) The International Trade Organization (ITO), which was not ratified by the US Congress and consequently did not become a reality. However, its primary function of liberalizing world trade was given to the General Agreement on Tariffs and Trade (GATT). Several GATT trade negotiations are of note. The Kennedy Round (early 1960s) originated due to US concerns with respect to the newly formed European Common Market. It resulted in a reduction in world tariffs by approximately 30%. The Tokyo Round (1970s) further reduced tariffs and addressed issues of non-tariff barriers, such as quotas. Most recently is the Uruguay Round, which concluded in 1994. Its major accomplishments included reduced barriers to trade in services, protection of intellectual property and
liberalization in agriculture. One consequence of the Uruguay round was the transformation of GATT into the World Trade Organization (WTO), a new institution with the same primary objective of trade liberalization.

Decolonization

The post World War II era is marked by two major geopolitical events, the period of decolonization and the Cold War. The period of nation emergence from European colonies is known as decolonization. Shortly after World War II, Great Britain decolonized South Asia, leading to the partition of British India into India and Pakistan. France, as a result of the Algerian Civil war, decolonized in late 1950s and early 1960s. Portugal, the last of the European colonizer, granted independence to the last of its colonies in the middle 1970s. This means that many developing countries are relatively young, especially those in Africa, the Middle East and South Asia.

The newly liberated countries had to choose which economic structure to adopt to achieve their developmental objectives. Many countries adopted Socialist policies, giving government a very large role in their economies. Their choices, by and large, were a function of distancing themselves from their former colonial masters. Another option available was Keynesian policy, whose central tenet believed government should play an active role in the economy to combat recessions and unemployment; Keynesian policy was practiced in the United States and other stalwarts of market economics. A third choice was the example set by Stalinist Russia, who in relatively quick time transformed the Soviet Union from an agrarian to industrial society.

Import Substitution

These new nations adopted government controlled economies, which relied on import substitution strategies to achieve industrialization. Import substitution meant these countries fostered the growth of industries to produce goods being imported, usually from former colonialist. The basic premise for this policy assumed the colonial economic relationship was one in which the colonialist exploit its colony by importing its raw materials and then exporting high-valued manufactured goods back to it. This cycle of exploitation could be broken if the colony used its raw materials to manufacture its own goods.
While the notion appears to be compelling, it is a movement away from efficient resource allocation. Newly formed manufacturing industries in the young nations were relatively inefficient and required fairly high levels of protection from imports, mainly from the industrialized countries. Guarded by protectionist barriers, these industries did not have the incentive to become efficient. While import substitution policies did initially succeed in producing some economic growth, they were not sustainable. Many nations in Africa, South Asia and Latin America saw their economies stagnate after an initial growth spurt. Several Southeast Asian nations, after initially implementing import substitution policies, adopted export promotion strategies. Here they would focus their industrial efforts on producing goods that were competitive in global markets. They created industries whose products had high world demand, required labor-intensive production, and had economies of scale. Items not consumed at home could be exported.

Oil Price Shocks

The oil price shocks of the 1970s forced many Americans to realize that the US economy was not independent from the rest of the world. The recessions following the oil crises of 1973 and in 1979 led to both recession and inflation simultaneously. The oil price shocks set into motion events that are still present in today’s global economy.
Many oil exporting countries, especially in the Persian Gulf area, saw their export earnings raise faster than they could spend them. The surplus earnings, which were denominated in US dollars, found their way into the global financial system. In other words, these petro-dollars were deposited in the major banks of the US and Europe. These banks, now flush with new deposits, had to find new borrowers in order to remain solvent. Importing-developing countries had a great need for these resources to finance the now higher cost of oil. Some oil exporting developing countries enacted development programs that outspend their oil earnings. The size of many developing countries debt ballooned.

International Debt Crisis

Two events in the US precipitated an international debt crisis. To begin with, Mr. Paul Volker, the Chairman of the Federal Reserve System, instituted a very tight monetary policy to fight the double-digit inflation in the US. Reducing the money supply resulted in an increase in interest rates. This increase in interest rates in turn increased the interest payments paid by developing countries to service their huge debt. Secondly, President Ronald Reagan instituted a supply-side economic policy, plunging the US economy into the worst recession since the Great Depression. With the economy in the US in a severe downturn the demand for developing countries products fell.

Developing countries were now between a rock and a hard place. On the one hand their debt service payments were rising while at the same time their ability to earn the income to pay their debt obligations was falling. Mexico, Argentina, Brazil and many other developing countries either defaulted on their debt or underwent IMF restructuring programs requiring stringent austerity measures. One group of countries, however, weathered the storm. Export promoters allowed price adjustments to shift their production away from energy intensive production. Countries that followed import-substituting policies stagnated. The 1980s is often referred to as the “lost decade” in Latin America. Using the Asian Tigers of Korea, Hong Kong, Taiwan and Singapore as a model, many import substituting countries changed their policies. They became more market friendly, opening their economies to the global economy. One major example is Mexico, who joined the US and Canada in the North American Free Trade Agreement in 1994.
Most developing nations saw the benefits of becoming linked to the global economy. Industrial nations no longer were viewed as neo-colonial exploiters, but as markets for developing countries= goods. Further integration of capital markets led to the emerging market phenomena. Investors in industrial countries could now purchase equities from a variety of newly formed stock markets in Argentina, Chile, Thailand, Malaysia, and so on. This inflow of financial capital allowed developing countries to invest in building new factories and infrastructure speeding up their economic development.

The Cold War

Some political scientists viewed the world as being divided into three groups of nations. The first-world consisted of the western democratic industrial nations; the second-world was made up of the communist nations; the third-world, a term still in use today, referred to the developing nations. The Cold War was an ideological battle between the first and second worlds. Each believed the other wished to spread its influence and dominate the world. The actual hostilities that took place were in the third-world. The Korean War, Vietnam War, and numerous other conflicts were, at their core, battles between the first and second worlds for the allegiance of third world nations. The end of the Cold War occurred with the fall of the Soviet Union in 1991.

The Soviet Union essentially disintegrated after its Eastern European allies overthrew their communist governments. The fall of the Berlin Wall in 1989 represented the death knell of the Soviet Union. With the Iron Curtain no longer in place, central Europe was free to reach out to the west, adopting market principles and opening up trade with their former enemies. Millions of skilled, low-cost workers were available and western companies set up shop to take advantage of the situation.

Initially there were difficulties integrating former East Bloc countries into the European fold. Transforming both economic and political systems in these countries proved to be challenging but over the course of a decade most eastern European countries now enjoy a much higher standard of living than they experienced under communist rule.

To an even greater extent Russia has had its own challenges in bringing about its economic and political transitions. As with its former allies in Europe, Russia attempted a simultaneous approaches to it reforms in both areas, but the results have not been as
successful as with the European countries. Corruption and a lack of transparency in the post-communist government has hindered confidence and growth. The Russian economy now is reliant on primary product exports, in particularly petroleum. Once home to world class science and high human capital, Russia’s economic and political back sliding has been discouraging.

Globalization

Throughout the rest of the world, previous policies of protectionism and isolationism gave way to globalization. Following the Cold War, distance ceased being a decisive factor in competition of market share. Borders mattered less as cross-border investment exploded. In 1992, total foreign direct investment was $90 billion; in 1999, it equaled $400 billion. Market deregulation and privatization, as well as mergers and acquisitions, developed an economic interaction based on mutual interdependence. Europe’s switch to a single currency, the euro, brought a surge in cross-border merger activity. Because of this growing integration of economies, developing countries depended on developed countries to keep markets open, ensuring market access and integration into the multilateral trading system.

The growth of the Internet assisted in generating an environment conducive to globalization by creating an immediate and transparent layer of communication and commerce, as well as bringing instantaneous interaction and vast stores of information. The Internet strengthened cross-border investment by allowing a swift and simple flow of capital. This global acceleration is seen in the demand for production lead-times, which are practically at zero. With local markets or manufacturers able to sell globally, demand has increased. E-commerce allows for the exchange of goods, services, and information, creating a platform for distribution of wealth and capital, and by allowing the communication of all facets of business information, the Internet is changing the market dynamics of global commerce. The survival and growth of a company is dependent on its ability to understand its relationship with this medium.

The global movement towards more market friendly economic systems is the major outcome of the end of the Cold War and the twentieth century. Countries embracing markets, both internally and externally, have created a world of growing interdependence. Globalization has had, and is having, a huge impact on the emerging geo-political
dynamics shaping the 21st century. Competition and power among nations will derive increasingly from economic proficiency rather than military might.

China
As noted in the course overview, one of the major accomplishments of the past quarter century has been the phenomenal rise of the People’s Republic of China. A brief review of recent Chinese history is useful to fully appreciate the rise of China. Prior to and following World War II, China was engaged in a civil war pitting the Nationalist Chinese against the Chinese Communists. This war concluded in 1949 with the Nationalists abandoning the mainland and settling on the island formerly known as Formosa, creating a new country, The Republic of China, also known as Taiwan. Note that today, Taiwan is not given national status but for a small number of countries. The victorious Chinese Communist Party (CCP), led by Mao Zedong, enacted policies collectivizing the Chinese economy with mixed results. China up to the time of the industrial revolution was the world’s largest economy. However, western imperialism proved to be disastrous for the Chinese with living conditions documented by several missionary authors before World War II. One book in particular should be on everyone’s reading list, *The Good Earth*, by Pearl Buck is a classic depicting the abject poverty of the common people prior to the Communist Revolution. Agricultural collectivization in the 1950s, a policy known as The Great Leap Forward, proved to be catastrophic costing the lives of tens of millions Chinese peasants. Chairman Mao continued his rule in the 1960s enacting a second disastrous policy known as the Cultural Revolution. Its main purpose was to solidify Chinese socialism by denouncing bourgeois elements in China’s economy and government. Millions of people were persecuted for essentially not being enthusiastic of the changes being enacted by the government. Crimes included having education, wealth, western leanings, or any other characteristic that was not in line with Chinese Communist Party philosophy. In the mid-1970s, China’s per capita income is estimated to be less than $100 a year, and China’s economy was essentially sealed off from the rest of the world.

Chairman Mao died in 1976. After a couple of years of upheaval within the ranks of the CCP, Deng Xiaoping became the new leader of Chinese Communist Party. Deng had been persecuted by the Red Army during the Cultural Revolution being viewed as a moderate and a reformist. The Red Army had been correct, Deng was not a hardened communist ideologue, but was a pragmatist who set China on the course of where it is
today. He is famous for his saying, “it does not matter the color of the cat, as long as it catches mice.” The meaning of this statement essential is a repudiation of government control of the economy in favor of markets. Capitalism is the cat that catches mice, and with that understanding, Deng began to enact “modernization” policies transforming China into a growing and robust economy. Many believe the turning point for China was 1978 and the solidifying of Deng’s control over the CCP. Allowing farmers to sell their produce in farmers’ markets dramatically raised their standards of living. Expanding access to markets continued such that in a country ruled by a communist party, there is now a vibrant and highly capitalized stock market, with Shanghai being one of a few global centers for finance. Deng encouraged the opening of the Chinese economy not only to trade but also allowing foreign multinational corporations to form joint ventures with Chinese companies. The end result has been a massive inflow of foreign capital in part responsible for the double digit growth rates of Chinese GDP.

China stands poised to become the world’s largest economy in the next twenty to thirty years. Chinese per capita income now exceeds $3000 and is growing. The twentieth century has been called the American century. If the Chinese Communist Party is able to reform the political structure in China allowing multiparty elections, then the twenty-first century may become the Chinese century.

China is not alone. India, the other behemoth country with a population that is expected to overtake China’s, is also on the ascendancy. As the world’s largest democracy, India will not need to make a political reform as is the case in China. India is posting high growth rates that will make it one of the top five world economies in due course. The world’s fourth most populous country, Indonesia, is also learning the lessons of globalization, markets and the consequent rise in its standard of living. As the rest of the world begins to catch up to the rich nations, it appears that the United States is in decline. This is not necessarily the case. The gap between rich and poor is slowly closing. The rich are not getting poorer, the poorer are getting richer.