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 that the "West" developed first.

Birth of Capitalism[1]

One can find examples of sustained economic growth throughout history, for example in the woolen industry in 13th century Flanders, and in 14th century Florence. Starting with the 11th century long distance trading flourished connecting thriving pockets of growth, between Venice and the Netherlands. However, by and large, 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 being 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 the institutions which facilitated the growth of the modern capitalist system.

Institutions which spurred the growth of capitalism	
Principle of Private Property	Joint Stock Companies
Deposit Banking	Insurance
Formal Contracts	International Financial Markets
Craft Guilds	Government Support of Opening Markets
Merchant Associations	

At the same time burgeoning industrialization and urbanization further weakened the feudal economy 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 that industrialization began in northern Europe. Protestant work ethic - fostered hard work, frugality, sobriety and efficiency, virtues which facilitated capitalism.

2) Rise of strong nation states - 16th through 19th century. The rise of strong nation-states created conditions conducive to capitalism. It provided domestic markets free of barriers to trade, 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 and consolidated 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, calculus, among many other findings led to practical applications in agriculture and industry. This period laid the scientific foundation for the industrial revolution. Social thought as expounded by David Hume, Adam Smith and Thomas Jefferson stressed the rights and responsibilities of the individual. This weakened 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 in not only in the United States, but also in England, Holland, and France.

The profits earned by capitalist from international trade, and the flow of gold and silver from the Americas, financed the accumulation of capital that 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 that the indigenous peoples of North America and Australia were not particularly numerous as compared to other regions. As the descendants of the English and French colonists grew in number and with new immigrant waves, primarily from Europe, the European population overwhelmed the indigenous peoples who were (at best) pushed aside. The European immigrants using their skills and by acquiring technologies from their home countries embarked on creating new industries. However, in Africa, the Indian Subcontinent, East Asia, and in Latin America 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 in 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. However, towards the end of the 19th Century Britain did not respond to 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. The machine gun, 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 Germany 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. 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. These measures 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 here at home and abroad.

Germany, resurfacing after a decade of deprivation, now faced a new economic challenge. Political turmoil ensued and the 1933 Germany 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 Germany highway system, the Autobahn, and encouraged production of the peoples car, Volkswagen. Flexing their new found military might Germany under the Nazis, invaded Czechoslovakia in 1937 and latter precipitated World War II with the invasion of Poland in 1939.

Post-World War II

In 1944 it became clear that the war was coming to an end, and the western Allied powers decided to again to 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 so 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, it's 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.

The post World War II era is marked by two major geopolitical events, the Cold War and the period of decolonization.   Some political scientists viewed the world as being divided into three groups of nations.   The Afirst-world@ consisted of the western democratic industrial nations. The Asecond-world@ was made up of the communist nations and the Athird-world,@ a term still in use today refers to the developing nations. The Cold War was an ideological battle between the Afirst@ and Asecond@ worlds. Each believed the other wished to spread its influence and dominate the world. The actual hostilities that took place were in the Athird@ world. The Korean War, Vietnam War, and numerous other conflicts were at their core battles between the Afirst@ and Asecond@ worlds for the allegiance of Athird@ world nations. The end of the Cold War occurred in the beginning of the 1990s with the fall of the Soviet Union.

De-colonization

This period also saw the birth of many new nations as the European powers decolonized. Shortly after World War II, Great Britain de-colonized South Asia leading to the partition of British India into India and Pakistan.   France, as a result of the Algerian Civil war, decolonized later 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.

These newly liberated countries had to choose which economic structure to adopt to achieve their developmental objectives.   Many of these 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. Furthermore, Keynesian policy, whose central tenet was that government should play an active role in the economy to combat recessions and unemployment, was being practiced in the United States and other stalwarts of market economics.   A third reason was the example of Stalinist Russia which in relatively quick time transformed the Soviet Union from an agrarian to industrial society.

Import Substitution

These new nations adopted government controlled economies that relied on import substitution industrialization strategies to achieve industrialization. Import substitution meant that these countries fostered the growth of industries that produced goods that were being imported, usually from the former colonialist. The basic premise for this policy was that their former 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 itself to manufacture its own goods. While the notion might appear 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. Behind 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. What was not consumed at home could be exported.

Oil Price Shocks

The oil price shocks of the1970s forced many Americans for the first time 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 rise 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. Many oil-importing developing countries had a great need for these resources in order to finance the now higher cost of oil. Some oil-exporting developing countries enacted development programs that outspent their oil earnings. The size of many developing countries debt ballooned.

International Debt Crisis

Two events in the US precipitated an international debt crisis. Mr. Paul Volker, then 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 increased the interest payments that developing countries had to pay in order 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. On group of countries, however, weathered the storm. Export promoters allowed price adjustments to shift their production away from energy intensive production. Countries who 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 up 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.

Also at this time the Soviet Union disintegrated after its Eastern European allies overthrew their communist governments. The example of a well-organized government controlled economy turned out to be a myth. The global movement towards more market friendly economic systems is the major outcome of the end of the Cold War. Countries embracing markets, both internally and externally, have created a world of growing interdependence. The events across the globe are transmitted everywhere through the global economy.

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[1] This section is base on E. Wayne Nafziger, The Economics of Developing Countries, 3rd edition, pps. 47-49.